

# FRANCHISING: FRAUD, CONCEALMENT AND FULL DISCLOSURE

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## I. INTRODUCTION

With Pilate reputed to have asked, "What is truth?" and then to have departed without waiting for an answer,<sup>1</sup> perhaps it is foolhardy to venture into the ramifications of fraud, whether in franchising or elsewhere. Yet the rapid erosion of the defense of "seller's talk" and the accentuation of all consumers' rights demand clarification of the evolving standards, with intense probing of the various factual categories of fraud in franchising itself. It is, of course, unnecessary to endorse the universally expressed view that the courts will not define fraud lest the ingenuity of man be employed to circumvent it.<sup>2</sup> Instead, such underlying principles might appear to justify the view that the benefit of any doubt should be resolved in favor of the innocent party.<sup>3</sup>

Although the franchise method of market distribution is not new, its ramifications have only recently been coming into focus, with considerable ignorance and debate still prevalent. With several studies staunchly supporting the validity of franchising,<sup>4</sup> Congressional inquiry has disclosed sharp criticism of such glowing accounts and decried the lack of reliable statistics.<sup>5</sup> Studies sponsored by industry<sup>6</sup> and government<sup>7</sup> have

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<sup>1</sup> F. BACON, *Essay on Truth*, in 1 BACON'S WORKS 261 (1846). See Fletcher, *Fairness and Utility in Tort Theory*, 85 HARV. L. REV. 537 (1972).

<sup>2</sup> See *FTC v. Sperry & Hutchinson Co.*, 405 U.S. 233 (1972), where the Court quoted with approval the House Conference Report on the original FTC Act regarding the impossibility of defining unfair practices, "[t]here is no limit to human inventiveness in this field. Even if all known unfair practices were specifically defined and prohibited, it would be at once necessary to begin over again . . . it would [be] . . . an endless task." *Id.* at 240, quoting H.R. CONF. REP. NO. 1142, 63d Cong., 2d Sess. 19 (1914).

<sup>3</sup> *Rigor v. Bucci*, 245 So. 2d 51 (Fla. 1971). As to fraud in sale of a franchise, cases requiring "'clear and convincing evidence,' or requiring any quantum of proof other than a preponderance or greater weight of the evidence, are hereby overruled." *Id.* at 53.

<sup>4</sup> See J. ATKINSON, *FRANCHISING: THE ODDS-ON FAVORITE* (1968); H. KURSH, *THE FRANCHISE BOOM* (new rev. ed. 1968); R. ROSENBERG & M. BEDELL, *PROFITS FROM FRANCHISING* (1969); C. VAUGHN, *FRANCHISING TODAY* (1970); R. METZ, *FRANCHISING: HOW TO SELECT A BUSINESS OF YOUR OWN* (1969).

<sup>5</sup> See *Hearing on the Impact of Franchising on Small Business Before the Subcommittee on Urban and Rural Economic Development of the Select Committee on Small Business*, S. REP. NO. 91-1344, 91st Cong., 2d Sess. 18-19 (1970) [hereinafter cited as *1970 Hearings*]. For this author's criticism of J. ATKINSON, *supra* note 4, see *1970 Hearings* at 3-4. The Atkinson text is set out in full in *1970 Hearings* at 57-110. Atkinson's response to the author's criticism is set out in *1970 Hearings* at 49, 52. For this author's critical review of METZ, *supra* note 4, see *1970 Hearings* at 43-48, concluding that the "credibility gap" between the facts and the reports was so tremendous that the FTC might well charge the franchisors with "deceptive acts or practices under section 5 of the Act."

<sup>6</sup> See "Franchised Distribution" (Conference Board, 1971).

<sup>7</sup> See U. OZANNE & S. HUNT, *ECONOMIC EFFECTS OF FRANCHISING* (1971). This study,

hurriedly been assembled to fill this breach, but the sharp differences in their conclusions would appear to indicate that resolution is still distant. Yet a fair understanding of fraud in franchising must commence with an analysis of the relationship at the factual, social, and economic levels.

In that inquiry, it will be necessary to examine recent developments in franchising as well as to probe the abuses and opportunities for abuse so rampant in this marketing method. Although the scope of such an undertaking could make the effort frustrating, it would otherwise be impossible to comprehend the significance of both misrepresentation and concealment in this complex business arrangement, as well as the evolution of their legal limits, in order to meet these novel challenges. As will be seen, the law has not been insensitive to such developments, both in the area of common law as well as in state and federal enactments.<sup>8</sup> While this discussion will focus on franchising, much of it is clearly applicable to all business transactions, perhaps reflecting a growing acknowledgment that sellers must stand responsible for the accuracy of all representations,<sup>9</sup> that buyers must be assured the full benefit of their bargain,<sup>10</sup> and that national standards are necessary in a country of such remarkable mobility.<sup>11</sup>

In resolving such issues of sophisticated fraud, much stress must be laid on the marked imbalance in the relationship of the parties as well as the severity of the franchisee's reliance on the franchisor.<sup>12</sup> Both of these factors were accentuated by the president of the leading chicken franchisor in his Congressional testimony that:

This emotional dream, the desire of every American to own his own business, to be his own boss, has many pitfalls. He is easy prey for the hot-shot promoter because the stakes are so high here. These small businessmen very often scrape up every dime they can borrow, beg or

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sponsored by the Small Business Administration, included a recommendation that the International Franchising Association [hereinafter cited as IFA] withdraw from circulation all copies of ATKINSON, *supra* note 4, on the grounds that, "The book presents grossly inaccurate data on [franchise] failure rates and would be very misleading to potential franchisees." *Id.* at 237. See also U.S. DEPT. OF COM., FRANCHISING IN THE ECONOMY 1969-1971 (1971), which is a statistical analysis based exclusively on reports submitted by franchisors, with no independent verification.

<sup>8</sup> See text accompanying note 211 *infra*; Brown, *Franchising: Realities and Remedies*, N.Y.L.J. — (1972).

<sup>9</sup> See Wall Street J., Jan. 21, 1972, at 1, col. 6; Note, "Corrective Advertising" Orders of the Federal Trade Commission, 85 HARV. L. REV. 477 (1971).

<sup>10</sup> Henningsen v. Bloomfield Motors, Inc., 32 N.J. 358, 161 A.2d 69 (1960). See also *Consumer Health and Safety*, 8 TRIAL 16 (Jan.-Feb., 1972) at 6.

<sup>11</sup> See Newberg, *Federal Consumer Class Action Legislation: Making the System Work*, 9 HARV. J. LEGIS. 217 (1972).

<sup>12</sup> See H. BROWN, FRANCHISING: TRAP FOR THE TRUSTING 41 (1969, Supp. 1970), noting that in advertising for the potential franchisee with "no experience required," such disparity is intentionally fostered by franchisors; Rosenfield, *Franchising and the Lawyer*, 42 FLA. B.J. 17 (1968), concluding that if the franchisor "is willing to give away any part of its basic contract it can only indicate a fatal weakness in the structure and philosophy of the company." *Id.* at 22.

steal in a lifetime of earnings, and put it all on one dream and hope of a franchise concept that very likely could have been misleading and misrepresentative and fraudulent. For that reason I think that the Senate, the Government of this country, should take some positive action to protect the small businessman. After all, he is the one that is going to get hurt, not the franchisor, because the franchisee is the one who puts up all the money and all the labor, in order to develop that business concept.<sup>13</sup>

Indeed, the extent of such overreaching has been conceded by the former general counsel of another fast-food franchisor, reporting that the industry "grossly oversold itself with promotions that were designed to work on the unrealistic hopes and daydreams of the naive . . ." leading to a "'boom' [that] was built on the desire for a fast buck, slick promotion and the American myth of Horatio Alger . . ."<sup>14</sup>

Such concessions by prominent spokesmen for the franchise movement might appear to indicate the lack of any need to belabor the issue of fraud, its prevalence being a matter of common knowledge. Unfortunately, such admissions are only directed toward malfeasance at the surface, with no inclination to go to the roots of the problem. Further, given the extremely broad scope of the functions in franchising, it will be demonstrated that even stretching the classical common law rules to their limit, statutory relief will still be required. A full exposition of the areas of abuse may provide guideposts for the creation of such new regulations.

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<sup>13</sup> Statement of John Y. Brown, Jr., while President of Kentucky Fried Chicken, given Jan. 20, 1970, before the Select Committee on Small Business, 1970 *Hearings*, *supra* note 5, at 190. See *Weaver v. American Oil Co.*, 276 N.E.2d 144 (Ind. App. 1971), where the exoneration clause in the oil company's dealership contract was held unenforceable because of unconscionability based on disparity of parties. Justice Frankfurter commented on this problem by asking:

Does any principle in our law have more universal application than the doctrine that courts will not enforce transactions in which the relative positions of the parties are such that one has unconscionably taken advantage of the necessities of the other?

. . . The law is not so primitive that it sanctions every injustice except brute force and downright fraud. More specifically, the courts generally refuse to lend themselves to the enforcement of a "bargain" in which one party has unjustly taken advantage of the economic necessities of the other.

*United States v. Bethlehem Steel Corp.*, 315 U.S. 289, 326 (1942) (dissenting opinion). See Comment, *Conscionability and the Freedom to Contract*, 22 BAYLOR L. REV. 99 (1970), particularly discussion of *Prince v. Miller Brewing Co.*, 434 S.W.2d 232 (Tex. Civ. App. 1968). See also *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445 (D.C. Cir. 1965).

For the most progressive franchise decision to date, see opinion of Judge J. Gelman (temporarily assigned) in *Shell Oil Co. v. Marinello*, (N.J., Superior Court for Bergen County, Law No. L. 31431-71 and Chancery No. C. 3094-71, decided July 21, 1972) 1972 T.C. ¶ 74,178, holding unconscionable the oil company's termination of a gasoline station dealership and the attempted eviction of the dealer under the intimately related sublease. Stressing the possible forfeiture of the dealer's goodwill, the onesided offer of contract renewals on a take-it-or-leave-it basis, the public policy implications of legislative renewal requirements in the absence of good cause, and the unclean hands emanating from both federal and state antitrust violations, the courts not only rejected the oil company's claims, but also ordered reformation of the contract of adhesion.

<sup>14</sup> Corliss, *Franchising: Time for a New Beginning? The Lawyer's Responsibility*, 15 BOSTON B.J. 7, 13 (1971).

## II. FACTUAL AND ECONOMIC ANALYSIS

### A. *Capital Matters*

The threshold question involves inquiry as to the very product being offered when a franchise is granted. Regrettably, the only clearly applicable legal definition derives from the requirement of the Lanham Act<sup>15</sup> that the licensor of a trademark must exercise quality control over its use by the licensee or suffer the risk of its loss.<sup>16</sup> Yet aside from the express provision of that statute that antitrust violations are not thereby condoned,<sup>17</sup> no one has seriously suggested that the perimeters of a franchise should be determined by a nonpreemptive federal statute primarily concerned with trademark law and the risks of passing off one's property as that of another.<sup>18</sup> To the contrary, as with other business entities such as corporations, business trusts, partnerships, joint ventures or proprietorships, it should be anticipated that state law would control. In the face of an almost total absence of applicable common law or statutory regulation, the prevailing view has been but to apply the simple rules of fraud in the inducement or contract precepts,<sup>19</sup> leaving trade regulation

<sup>15</sup> 15 U.S.C. §§ 1051-1127 (1970).

<sup>16</sup> Lanham Act §§ 5, 14, 45, as amended, 15 U.S.C. §§ 1055, 1064(e) (1), 1127 (1970); *E.I. DuPont de Nemours & Co. v. Celanese Corp.*, 167 F.2d 484 (C.C.P.A. 1948); *Morse-Starratt Products Co. v. Steccone*, 86 F. Supp. 796 (N.D. Cal. 1949).

<sup>17</sup> 15 U.S.C. § 1115 (b)(7) (1970). See *Timken Roller Bearing Co. v. United States*, 341 U.S. 593 (1951); *Phi Delta Theta Fraternity v. J. A. Buchroeder & Co.*, 251 F. Supp. 968 (W.D. Mo. 1966). See also *Developments in the Law, Trade Marks and Unfair Competition*, 68 HARV. L. REV. 814, 816-19, 895-906 (1955); Note, *Quality Control and the Antitrust Laws in Trademark Licensing*, 72 YALE L.J. 1171, 1181-82 (1963); Collison, *Trademarks—The Cornerstone of a Franchise System*, 24 SW. L.J. 247 (1970).

<sup>18</sup> It may be appropriate to reexamine the standards supposedly imposed upon franchising by the Lanham Act. In actuality, that statute merely prescribes that a trademark shall be cancelled if the registrant "does not control, or is not able legitimately to exercise control over, the use of such mark," 15 U.S.C. § 1064(e)(1), a provision quite different from a "requirement" that the franchisor exercise quality control over its licensee. Such a conditional cancellation may tolerate a privilege, but as in every other instance, the use of excessive power should result in the loss of the privilege. Furthermore, there may be some question as to the administrative zeal of the Patent Office to enforce the cancellation standards. See *Pfizer, Inc. v. Lord*, 456 F.2d 532 (8th Cir.) cert. denied, 406 U.S. 976 (1972). (With regard to patent cancellation, see remarks of district court recommending that the Department of Justice investigate the Patent Office, characterized as "the sickest institution that our Government has ever invented" and "the weakest link in the competitive system in America." *Id.* at 542). As the Supreme Court has recently commented on the abuse employment of a trademark, or any other right:

Even constitutionally protected property rights such as patents may not be used as levers for obtaining objectives proscribed by the antitrust laws. . . .

The trademark may become a detrimental weapon if it is used to serve a harmful or injurious purpose. If it becomes a tool to circumvent free enterprise and unbridled competition, public policy dictates that the rights enjoyed by its ownership be kept within their proper bounds. . . .

*Ford Motor Co. v. United States*, 405 U.S. 562, 576 n.11 (1972), citing with approval *United States v. Timken Roller Bearing Co.*, 83 F. Supp. 284, 316 (N.D. Ohio 1949), *aff'd* 341 U.S. 593 (1951). See Collison, *supra* note 17.

<sup>19</sup> See *Engbrecht v. Dairy Queen Co.*, 203 F. Supp. 714 (D. Kan. 1962).

to application of the federal antitrust laws<sup>20</sup> or their state counterparts.<sup>21</sup>

Yet although the great majority of franchise contracts have delineated a franchise as little more than an embellished license, revocable practically at will, almost every serious commentator now concedes that a franchisee obtains a far more substantial position, if not an actual property right.<sup>22</sup> Significantly, in the first two state enactments designed to regulate franchising,<sup>23</sup> a broad definition was adopted, with specific provision banning the termination or failure to renew a franchise except for good cause.<sup>24</sup> The same limitation has been widely enacted in state provisions to protect automobile dealers,<sup>25</sup> the clear implication of which is to acknowledge that the franchisee obtains far more than a mere contractual license, much in the nature of a status or a property right.<sup>26</sup> Since most of the current franchise litigation has arisen in the federal courts under the antitrust laws, it is not surprising that at least some pronouncement has emanated from that source. Not long ago, the Seventh Circuit Court of Appeals had occasion to observe that "we are in a day and age in which the value of the nationally advertised franchise is a matter of general recognition," the illegal destruction of which would involve "implicit" damage.<sup>27</sup> And much more recently, the same court expressly recognized "the vested interest a franchisee builds in his busi-

<sup>20</sup> 15 U.S.C. §§ 1-31 (1970).

<sup>21</sup> See, e.g., "Baby" FTC Act, MASS. ANN. LAWS ch. 93A §§ 1-10 (Supp. 1971).

<sup>22</sup> See, e.g., statement of John V. Buffington, General Counsel of the FTC, given January 27, 1970, before the Select Committee on Small Business, where he said that "franchisor's frequently speak of their relationship with their franchisees as being one of trust and confidence. It is truly a fiduciary relationship." 1970 Hearings, *supra* note 5 at —. See also Rosenfield, "Big Brother" as a Fiduciary: Suing the Franchisor, 76 CASE & COM., July-August, 1971, at 38; Brown, *Franchising—A Fiduciary Relationship*, 49 TEX. L. REV. 650 (1971) [hereinafter cited as *Fiduciary*].

<sup>23</sup> Franchise Investment Protection Act, WASH. REV. CODE ANN. App. 18.252x (Supp. 1971); Franchise Practices Act, N.J. STAT. ANN. 56:10 (Supp. 1972). See *Globe Liquor Co. v. Four Rose Distillers Co.*, 281 A.2d 19 (Del. Super. 1971) holding unconstitutional the retroactive application of a Delaware statute requiring distributorship renewal except for good cause; *contra*, *Ford Motor Co. v. Pace*, 206 Tenn. 559, 571-75, 335 S.W.2d 360, 365-67 (1960) (auto dealer statute); See Sept. 30, 1971, opinion of Arkansas Attorney General construing § 2 of Act 252 of 1971 (making it unlawful to charge on Arkansas franchise a royalty fee "which is greater than the lowest royalty fee which it charges to any other of its franchisers in the U.S.") to prohibit the entering of a "new-contract" charging "any greater royalty fee than the lowest contemporaneously being charged in other states for similar franchises."

<sup>24</sup> See WASH. REV. CODE ANN. App. 18.252x, § 18(2)(i) (Supp. 1971). Cf. *Alpha Distrib. Co. of Cal. v. Jack Daniel Distillery*, 454 F.2d 442 (9th Cir. 1972), where the court held that, absent anticompetitive motive or intent, exclusive distributorship that is dependent on best efforts, is terminable only for cause, but where there is no ascertainable term, duration is for reasonable time and thereafter terminable on reasonable notice.

<sup>25</sup> See Brown, *A Bill of Rights for Auto Dealers*, 12 B.C. IND. & COM. L. REV. 757, 758 n.5 (1971) [hereinafter cited as *Bill of Rights*]. See, e.g., MASS. ANN. LAWS ch. 93B, § 4(3)(c) (Supp. 1971).

<sup>26</sup> *Bill of Rights*, *supra* note 25, at 767, 801.

<sup>27</sup> *Fontana Aviation, Inc. v. Beech Aircraft Corp.*, 432 F.2d 1080, 1086 (7th Cir. 1970), *cert. denied*, 401 U.S. 923 (1971).

ness through years of effort and expenditures."<sup>28</sup> In a leading case, the court held that:

[I]n the economic context of present franchising trends, it is clear that a franchise license is marketable, separate and apart from the various products which the franchisees are required to purchase from and through the franchisor.<sup>29</sup>

After extensive analysis of innumerable franchise systems and the composite of functions involved in the complex relationship, this author has concluded that the property right obtained by a franchisee is in fact a legal status, possibly open to description as a license coupled with an interest.<sup>30</sup> Although the law has had difficulty in settling on an exact definition of various chattels real, such as a savings bank book, a bond, or similar embodiment of a chose in action in a documentary form, the ultimate significance lies in the attributes to which such a vested interest may be entitled. While there is hardly agreement as to the minimum characteristics which a franchise must provide, perhaps that can be better discerned after the ensuing discussion of each of the elements which are involved in many types of franchises.

It should be evident that this consideration of the very nature of a franchise goes to the root of the question of misrepresentation. In advertising the franchise and even in the offering of a "franchise agreement," the franchisor is implicitly representing that at least certain minimum expert services and legal rights are being offered to the prospective franchisee. If, in fact, the agreement reserves to the franchisor unreasonable rights of abuse either in the operation, disposition, or destruction of the capital asset, then fraud can be found. To those who profess shocks, the proof may be found in the following discussion of the substantial bundle of fundamental rights implicit in a franchise. The material denigration of a minimum composite of those rights necessarily demonstrates that a prospective franchisee has been actionably misled. Quite simply, if a consumer purchases an automobile, it is essential that he receive a vehicle with certain minimum specifications. For the far more crucial transaction involved in the acquisition of a franchise, frequently

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<sup>28</sup> *Milsen Co. v. Southland Corp.*, 454 F.2d 363, 366 (7th Cir. 1971).

<sup>29</sup> *Siegel v. Chicken Delight, Inc.*, 311 F. Supp. 847, 849 (N.D. Cal. 1970), *aff'd* 448 F.2d 43 (9th Cir. 1971), *cert. denied* 405 U.S. 955 (1972). In bankruptcy proceedings, it is thus improbable that a franchise can be terminated as an "executory contract." See Bankruptcy Act, § 313(1), 11 U.S.C. § 713(1) (1970). In *United Artists Corp. v. Strand Productions*, 216 F.2d 305 (9th Cir. 1954), in reorganization proceedings, a motion picture producer was not allowed to terminate a license granted for the marketing of motion pictures. Earlier, it had been held that in a publisher's bankruptcy proceeding, while recognizing a composer's equitable lien on a copyright, he was not allowed to ignore the publisher's common law proper right in the copyright. *Waterson, Berlin & Snyder Co. v. Irving Trust Co.*, 48 F.2d 704 (2d Cir. 1931).

<sup>30</sup> See *Fiduciary*, *supra* note 22, at 660.

representing the investment of one's life's savings, it would appear unconscionable to condone any less.

As to the generic rights being granted, at least in the case of the major oil companies, the deceit may lie in their universal representation that their dealers are lessees, rather than franchisees. In support of that specious claim, the oil companies note that no capital payment is required, that dealers are only required to purchase about five thousand dollars of tires, batteries, and accessories (TBA), and that upon termination or non-renewal of the lease, their gasoline and related products are repurchased. But such protestations are wholly inconsistent with the companies' licensing of their tradenames and their exercise of quality controls over their use. Nor can they continue to pass themselves off as simple lessors in view of their universal refusal to grant or renew a lease unless the sales of the lessor's gasoline and TBA have been satisfactory.<sup>31</sup> They wholly ignore the dealer's goodwill.

Another basic factor is the full identification of the franchisor. When the franchisor uses a wholly owned subsidiary or a sister corporation as the contracting party, usually with undercapitalization<sup>32</sup> as a shield against unlimited liability,<sup>33</sup> deception appears to exist. Variations of this problem arise when notable personalities with no actual affinity lend their name to the franchisor<sup>34</sup> a ploy clearly intended to lull the prospect into a false sense of security. Although many franchisors have erroneously claimed that the record of abuses is attributable to the usual criminal fringe that can be found in any industry,<sup>35</sup> it is of course true that franchising has been a magnet for many criminal elements, bank-

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<sup>31</sup> *FTC v. Texaco Inc.*, 393 U.S. 223 (1968). For discussion of other oil company abuse, see *Fiduciary*, *supra* note 22, at 655-57.

<sup>32</sup> Where the franchisor has insufficient capital to fulfill its representation of support systems for the franchisees, there may be implicit fraud. A similar question could arise where the franchisor is either wholly or primarily dependent on the continuous sale of more franchises, rather than on its ability to survive in a supervisory capacity.

<sup>33</sup> For discussion of the newly developing concepts of "piercing the corporate veil," particularly where fraud is involved, see text accompanying notes 129-30, *infra*. As a supposed defense to such a remedy, a newly drafted franchise clause requires the franchisee to forswear any future claim against the franchisor's parent corporation.

<sup>34</sup> See Goodwin, *The Name of the Franchising Game Is: The Franchising Fco, the Celebrity, or Basic Operations?*, 25 BUS. LAW 1403 (1970); Amstar Corp., 3 TRADE REG. REP. ¶ 20,004 (F.T.C. 1972). See also Amstar Corp., 3 TRADE REG. REP. ¶ 19,696 (F.T.C. 1971), allegation of false advertising that national football and baseball leagues selected two brands of sugar for superior quality and nutritional value, whereas endorsement was based on monetary consideration furnished to the leagues. For report of extensive criticism of the use of the "trusted personality" in advertisements for the mail order sale of hospital insurance, see Wall Street J., June 22, 1972, p. 38, col. 1.

<sup>35</sup> See statement of IFA given in Washington, D.C., on February 15, 1972, to FTC hearings officer on the FTC Proposed Trade Regulation on disclosure to prospective franchisees. For a key to the names of prominent franchisors that have allegedly been guilty of various practices disclosed herein, see author's statement at the same hearings, given on February 16, 1972. The identically erroneous claim has been made to resist adoption of national consumer fraud legislation. See Newberg, *Federal Consumer Class Action Legislation: Making the System Work*, 9 HARV. J. LEGIS. 217, 218-21 (1972).

rupts, and renegades driven out of securities sales, installment land sales, and insurance because of fraudulent practices.<sup>36</sup> While few would dispute the propriety of required disclosure in such criminal reference, of equal significance are those clauses giving the franchisor the right to assign the contract at will and then to be relieved of all further liability upon the assignee's assumption of the contract.<sup>37</sup>

Closely related is the issue of the trademark license which goes to the very heart of the franchise. Not only implicitly, but also in franchise brochures and almost always in the franchise agreement, the franchisor represents that it has developed substantial goodwill in the servicemark, the protection of which is used as justification for many repressive practices. If, in fact, the mark is one in the public domain or newly adopted or new in a particular territory, a basic misrepresentation could be present.<sup>38</sup> More subtle is the case in which the license is limited to use with a single product, such as chicken, or with a fractionalized service, such as an employment agency solely for clerical employees. It may hardly be apparent that the franchisor has plans to grant franchises under the same tradename and in the same area, but for a different product such as roast beef or, in the employment agency case, for blue collar workers and even later for temporary services. The intention to dilute the value of the trademark through fractionalization would appear to be a fact capable of supporting a claim of misrepresentation.

In almost every franchise, site selection and control are of critical importance. Included in the franchisor's advertised expertise is that of skill in choosing a location. In fact, ordinary real estate services may be employed with the franchisor content to allow numerous franchisees to gamble on the selections.<sup>39</sup> Even where the franchisor assumes some financial risk by signing the lease, the actual exposure for the brief period of a potential vacancy hardly compares with the cash profit obtained through the sale of the franchise. Site problems become more complex when they involve control and profits. Many franchisors insist upon leasing the premises directly, then subleasing them to the dealer at a sub-

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<sup>36</sup> See statement of New York Attorney General Lefkowitz to Committee on Franchise Licensing of the New York Legislature, Sept. 28, 1970. See also staff report on franchising submitted to the N.Y. Attorney General, released January 7, 1970, reprinted in H. BROWN, *supra* note 12, at 194.

<sup>37</sup> For lack of a more appropriate description, the author has characterized this as a "compulsory novation" clause, a concept comparable to Professor Williston's "weasel" clause. The essentials of consideration are discussed in 1 S. WILLISTON, *CONTRACTS* § 102A (3d ed. 1957). See *Gill v. Richmond Coop. Ass'n*, 309 Mass. 73, 79-80, 34 N.E.2d 509, 513 (1941) (plaintiffs' promise to buy such milk as they might order is illusory and lacking in consideration).

<sup>38</sup> See Lanham Act § 43, 15 U.S.C. § 1125 (1970). See also Star, *The Consumer Class Action*, 49 B.U.L. REV. 211, 244-47 (1969).

<sup>39</sup> See *Barton's Candy Corp.*, 3 TRADE REG. REP. ¶¶ 19,554, 19,609, 19,786 (F.T.C. 1971), consent order to cease and desist against franchisor's deceptive claims of survey and electronic site analysis.



stantial profit.<sup>40</sup> Alternatively, the dealer must collaterally pledge its lease to the franchisor. In each instance, the underlying purpose is to guarantee that upon termination of the franchise for any reason, any goodwill developed in the site will ultimately redound to the franchisor. Since it would be difficult to claim that such an arrangement had not been disclosed, the complaint must be couched not merely in terms of the failure to disclose the facts, but in the failure to explain the full significance of the arrangement.

In fact, it would seem necessary to expose the reverse of such a situation where the franchise provides that it will automatically terminate if for any reason the lease of the premises comes to an end. Aside from such matters as nonpayment of rent, the lease may terminate without fault, such as through a fire or a taking by eminent domain or merely through the ending of the term of years. While such a defeasance clause in the franchise would then become effective, such a calamitous forfeiture is hardly understood by the prospective franchisee, especially where a substantial investment is required.

In a great majority of franchises, there are capital matters involving the design, engineering, construction, or installation of a building, signs, and equipment. Elements of deception may be involved in the alleged expertise of the franchisor in each of such matters. Of equal importance, the franchisor may obtain a "kick-back" from the third party vendor. Such hidden benefits may trespass on express representations that the franchisee will share in the benefits of mass purchasing power.<sup>41</sup> Given the revulsion toward "kick-backs," there may be a strong inclination on the part of courts to find either active concealment or a duty of full disclosure.

Often such capital assets are leased, rather than sold, to the franchisee, much in the fashion of a sublease of the premises. Here, the problem involves not only the extent of the profit, but also a question of mathematics. For example, if the franchisor leases the premises with a rental of five percent of gross sales, then subleases to the franchisee at six percent, this can hardly be described as a "one percent add-on," a proper assessment being an addition of twenty percent. Similarly, where equipment is leased to the franchisee with a stated addition of seven percent of the cost in order to cover the franchisor's investment, the putative rate of interest on a direct reduction pay-out would in fact approximate double that amount, or fourteen percent. Where the putative amortization is calculated on a ten year basis, but the equipment has an actual life ex-

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<sup>40</sup> Such arrangements could involve a tying violation under the Sherman Act § 1, 15 U.S.C. § 1 (1970). *FTC v. Texaco Inc.*, 393 U.S. 223 (1968).

<sup>41</sup> See *Barton's Candy Corp.*, 3 TRADE REG. REP. ¶¶ 19,554, 19,609, 19,786 (F.T.C. 1971), for a violation of the deceptive practices prohibition of the FTC Act § 5, 15 U.S.C. § 45 (1970), arising from franchisor's failure to disclose "kickbacks" to prospective franchisees.

pectancy of half that period, then the fact is that the franchisee will have a double cash flow burden within a predictable number of years. Such financial outlay might well guarantee the failure of the dealership within a foreseeable period. Although it must be conceded that it may be impossible to explain such complex matters to a prospective franchisee, particularly to those of limited business experience, such gross disparity in intricate matters is in itself significant in the delineation of legal duties.

Other complex factors involve availability and feasibility. For example, if the particular franchise requires a location in a shopping mall, the diminishing availability of such sites could be a crucial factor. Similarly, if mortgage financing is required, the general diminution of such funds or even the specific chilling resulting from the financial community's disillusionment with franchising, could spell disaster for the prospective franchisee. Both of these factors may be combined where the franchisor advertises a "turnkey"<sup>42</sup> operation, while aware of the fact that provision of such a facility is no longer feasible. Although such factors have been accentuated during the recent recession, it would appear obvious that the knowledgeable franchisor is wholly aware of such limitations, as compared with the limited knowledge of the unsophisticated, prospective franchisee. Even where the franchisor may not have expressly represented the availability of such assistance, it is in areas of such sophisticated fraud that affirmative duties of disclosure may be requisite.

In the realm of competition emanating from the franchisor, there are numerous practices which have the clear potential of destroying a previously granted franchise. Perhaps the most widely recognized system is that known as dual distribution, a euphemism describing the practice of distribution at the same market level and in the same market area through company owned outlets and franchised units. To the general public, including potential franchisees, such units are indistinguishable. In each instance, however, the company unit enjoys innumerable competitive advantages and, in any necessitous situation, its preferential treatment can imperil the very existence of the franchised unit. There are a number of variations of such competition. In one, the franchisor may grant an excessive number of franchises in a particular market area. Even if the situation may ultimately become stable, the interim dislocation may be enough to destroy the originally granted franchise, particularly in a marginal case. Occasionally, the franchisor may unwillingly inherit a dual franchise where a franchisee fails for independent causes or simply terminates. While the resale of such a unit would stabilize the preexisting

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<sup>42</sup>In a "turnkey" franchise, the franchisor undertakes to provide a complete business package, ready for the franchisee to start operations. Both site approval and availability of mortgage financing offer palatable excuses for endless delay, during which period the franchisor may have the free use of the franchisee's substantial cash payment.

situation, it is virtually impossible to determine whether the franchisor is genuinely striving to dispose of the outlet on reasonable terms or is secretly retaining it for purposes of market control. Quite independently of the boiling controversy concerning the propriety of such practices under antitrust principles,<sup>43</sup> a more relevant question devolves from the realm of the franchisor's representations at the time of granting the franchise. Given the severity of such a competitive threat, it may well be that the law must construe the grant of a franchise as an implicit representation that such a destructive practice does not exist. Alternatively it could require not only a full disclosure of such franchisor practices, but also an exposition of the full import of such competition sponsored by the very franchisor that granted the franchise.

Closely related is the practice of recapturing franchises either for operation as a company store or for resale at a profit.<sup>44</sup> Such recapturing can be on the basis of voluntary acquisition or through the use of oppressive tactics. For example, given the franchisor's almost universal access to the franchisee's confidential business records, the franchisor can take advantage of its position of trust to direct its reacquisition to the most successful units or those in a concentrated area where economies of scale can be facilitated. There may well be a record of harrassment and abuse in order to depress the price at which a franchisee may be forcefully induced to sell. Even if the individual franchisee is offered a fair price for the going value of the specific franchise, there is implicit abuse of the franchisees as a composite group since eventually the franchisor will have the greatest benefit from the system as a whole, with the franchisees left with the marginally successful units. While it might be thought that such a program would be too devious for deliberate adoption by franchisors, it is in fact a prevalent practice among many major franchisors.

Such a reacquisition policy may be abetted by a wide variety of contract provisions whose meaning or purpose is obfuscated. For example, a right of first refusal as against any bona fide third party offer may in fact be crippled by a clause prohibiting public advertisement that the franchise is for sale until after the franchisor has declined to purchase, thus chilling any opportunity to obtain a fair market value. Or an express option to purchase may provide an agreed formula that precludes fair valuation, using such ruses as an inadequate factor for capitalization of aver-

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<sup>43</sup> Most of these practices are specifically prohibited in MASS. ANN. LAWS ch. 93B, §§ 1, 4(3) (K) (Supp. 1971). See *Bill of Rights*, *supra* note 25, at 804. In *Rea v. Ford Motor Co.*, 5 TRADE REG. REP. ¶ 74,015 (W.D. Pa. May 27, 1972), an independent dealer recovered \$5.6 million from the factory because of the antitrust violation arising from the direct competition of company owned stores. *Wall Street J.*, May 30, 1972, p. 12, col. 2.

<sup>44</sup> Oxenfeldt & Kelly, *Will Successful Franchise Systems Ultimately Become Wholly-Owned Chains?*, 44 J. RETAILING 69 (Winter 1968-69). According to franchisor's affidavit in a pending class antitrust suit, in the past three and one-half years, it has reacquired a total of 109 of its 250 franchises, apparently for subsequent resale at a profit. See *In re International House of Pancakes*, 331 F. Supp. 556 (Jud. Pan. Mult. Lit. 1971).

age net earnings or artificial charges to expense for the franchisee's putative salary or the use of an accelerated depreciation formula. While provision may be made to pay the fair market value of both capital and inventory items, that may be confined to tangible property so that there will be a total forfeiture of the franchisee's goodwill.

Whether affirmative representations or active concealment can be found in the particular case, the unconscionability of such contractual artifices would appear so obvious that the agreement itself would have evidentiary value. Without reviewing the many other practices and contractual terms that can be used to terminate a franchise, it may suffice to note that any of these can also be abused to abet a policy of reacquisition. Here again, the extremely unfair nature of such a program may well import into the grant of a franchise an implied representation that such a practice does not exist. Alternatively, it may evoke a broad requirement of affirmative disclosure.

Possibly the most basic representation to every prospective franchisee, either in express terms or by clear imputation from the use of the word "franchise," is that the grantee will obtain "a business of your own." It is not difficult to infer that such a colloquialism imports the concept of a property interest, concededly an intangible, as well as the normal attributes of such a "vested interest."<sup>45</sup> Without unduly straining the limits of that legal concept, it would appear to include ownership of whatever goodwill the dealer develops, together with freedom to transfer it, subject only to such reasonable approval by the franchisor as might be necessary to protect the maintenance of quality control required under the Lanham Act.<sup>46</sup> Even so, given the alacrity of the franchisor to accept a wholly new franchisee with "no experience required," there would appear little room for umbrage in its right to approve a transferee. This is particularly suspect because the franchisor is a direct competitor in the sale of franchises.

Further, it may secretly use its right to approve transfers in order to exact assent to unreasonable conditions. As will be seen, since it may be practically impossible for a franchisee to comply with the numerous standards imposed by the contract and, even more, in the manual of operations, it would appear clearly unreasonable to condition the approval of such a transfer on the franchisee's having complied with all such provisions. Similarly, it would appear unconscionable to condition the approval on the franchisee's granting a general release, potentially forfeiting valuable litigational rights.<sup>47</sup>

Even before reaching the ultimate disposition of the franchise either

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<sup>45</sup> See note 28 *supra*.

<sup>46</sup> See note 16 *supra*.

<sup>47</sup> See note 13 *supra*. Equally reprehensible is a general release incorporated into renewal of short-term contracts.

by sale or gift, that property right may be involved in some form of equity financing or in borrowing with a pledge of all or part of the business assets. The usual prohibition of all such activity would appear to be unrelated to the business or legal requirements of quality control. Although it may be impossible to ignore the equitable or anticompetitive implications of many of such repressive practices,<sup>48</sup> the crucial factor here is that any such impugning of the franchisee's vested interest would appear to ground an action of fraud emanating from the "business of your own" representation.

Intimately involved with that concept is the question of the time duration of the franchise. While there are no legal standards as such, certain customs have become established in some industries. For example, in many of the older industries, such as in automobiles, gasoline stations, and most manufacturers' distributorships, a one year term has been widely prevalent, though under recent criticism there has been some movement to increase this to three to five year terms. In many of the more recent franchises, particularly in fast-food and the service market, the terms have widely been for ten to twenty years or more, frequently with options for renewals. As previously adumbrated, however, the express representation in such "time" clauses may in fact lay the basis for deceit either through devious contract terminology or through complex legal maneuvers.

For example, the gasoline dealership contract for one year may in fact be tied to a supply contract giving either party the right to terminate on thirty days' notice. Or there may be an equipment lease providing for the free loan of the tanks, pumps, and other capital assets, but also being subject to cancellation on twenty-four hours' notice. In all cases, with the dealer having devoted his life to the station, he is totally at the mercy of the oil company at each lease renewal,<sup>49</sup> it being not unusual practice for the franchisor to grant one to three year leases at the beginning, but to shift to six month or even three month leases after the station has become fully established. In automobiles, as economic abuse has accelerated,<sup>50</sup> the dealer's only chance for survival has been through the consolidation of stores into larger and larger units, thus grounding a policy of attrition, nonrenewals, and similar destruction of the dealerships.<sup>51</sup> In one fast-food chain, it was alleged that a

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<sup>48</sup> See *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (1967), for a per se anti-trust violation in restraints on alienation.

<sup>49</sup> *FTC v. Texaco Inc.*, 393 U.S. 223 (1968).

<sup>50</sup> See *Bill of Rights*, *supra* note 25, at 761-76.

<sup>51</sup> Such a trend is apparent from the fact that of the 49,000 automobile dealerships in existence at the end of World War II, only 27,000 now survive, representing a net annual reduction of 1,000 dealerships. The author is personally aware of numerous instances in which an auto factory has deliberately terminated or declined to renew small dealerships in favor of so-called low-profit high volume distributorships.

major corporation suddenly decided that franchising was no longer desired, whereupon it declined to renew the *thirty day* leases for all 640 of its franchisees.<sup>52</sup>

Unfortunately, however, even those franchisors who have been cajoled by judicial<sup>53</sup> and public criticism to extend the time period of their dealerships should be fully aware that such time clauses contribute to the franchisee's false sense of security. It may be repeated that since the standards of almost all franchises may be impossible to attain, the franchisee may at all times be subject to termination. Whether the supposed term is thus subject to self-destruction or burdened with illegal conditions, the present issue is whether the very representation as to duration is implicitly deceptive.

If, as argued, the franchisee obtains a vested interest in his business, the law will ultimately rule as a matter of public policy that in order to prevent an unconscionable forfeiture, the franchise is not subject to any "termination" or "failure to renew." Although the franchisee may be subject to reasonable quality control, the alternative to the penalty of forfeiture for noncompliance may be to permit a suit for damages or to require the franchisee's disposition of the business within a reasonable time period, but with at least a fair opportunity to obtain its fair market value.<sup>54</sup>

Perhaps this delineation of the more important capital aspects of a franchise can serve a broader purpose in evaluating the price charged by the franchisor for the acquisition of the franchise. While it is difficult to declare that a franchisor is not free to charge whatever the traffic may bear, the standards of misrepresentation may provide some fair limitations. At the outer limit, if the franchise system is patently incapable of success or if the franchisor has shown reckless or grossly negligent disregard for such concerns, any capital charge would appear to be implicitly false. In the great majority of cases, businessmen have chosen to franchise because of a lack of capital or in order to avoid the risk of a loss of capital. While such self-interest may be obvious, perhaps the prospective franchisee is entitled to a full disclosure of the franchisor's finances, particularly those which are devoted to the franchise system.

Just as basic is the usual prescription of a royalty on gross sales as a charge for the use of the franchise. If the percentage charge is excessive,

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<sup>52</sup> See *Battle v. Ralston Purina Co.*, No. 70-1878-F (C.D. Cal., filed August 21, 1970) (Jack-in-the-Box franchise).

<sup>53</sup> See *FTC v. Texaco Inc.*, 393 U.S. 223 (1968).

<sup>54</sup> See FTC's complaint in *Adolph Coors Co.*, 3 TRADE REG. REP. ¶ 19,454 (F.T.C. 1971), which was a proposed order detailing cancellation procedure for distributors, including 180 day notice with written reasons and granting distributor right to sell his interest to a third party, subject only to manufacturer's reasonable right of approving third party's qualifications. See also *Noble v. McClatchey Newspapers*, 5 TRADE REG. REP. ¶ 73,917 (N.D. Cal. April 10, 1972) (after termination, franchisor cannot restrain alienation of deal ship).

it may preclude the franchisee's ability to remain in business. In any case, the franchisor's primary concern becomes one of gross sales, while the interest of the franchisee lies in his net profit. This fundamental conflict of interest will also exist wherever the franchisor's prime concern is the distribution of his product, as in the case of automobiles, gasoline, farm machinery, or in a whole array of lesser industries in which franchising is prevalent. While franchisors constantly harp on the need for joint effort, they thus conceal or sublimate this adversary interest that permeates every aspect of the relationship.

Although this litany of fraud in the capital arena can only be considered illustrative, it should unfold a vista of the variegated form such deceit may take. While encouraging a more replete examination of the scope of such fraud, it may aid in the further delineation of the characteristics of a franchise in order to ground the area in which misrepresentation may abound. For example, until it is fully acknowledged that a franchisee has a vested property right, that interest cannot possibly ground deceit in the franchisor's representations. At the same time, all of such considerations should contribute to the evolution of standards both at common law and in new regulation.

#### B. *Operating Matters*

Given the wide panorama of items in the sphere of operations, it is understandably impossible to cover them all, together with the endless variations in each. As a composite, each of these profit and expense items is reflected in all representations concerning the profitability of the franchise. The latter can be in the form of profit and loss projections, descriptive phrases, or references to specific services of acute importance. The very grant of a franchise is an implication that a profitable business can be maintained. But more affirmatively, there is implicit the understanding that with the use of expertise the franchisor has formulated a profitable business package,<sup>55</sup> that its expert services will be constantly available as support systems for the franchisee, and that through their cooperative effort the franchisor and franchisees will be able to do together what neither could do alone. Indeed, a leading franchisor spokesman has defined the "franchise relationship" as:

[B]asically, just doing together with a group of people what cannot be done alone. That is from mass purchasing power, advertising, from uniform-

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<sup>55</sup> See *Motel Managers Training School, Inc. v. Merryfield*, 347 F.2d 27 (9th Cir. 1965) (franchisor broke its "implied promise" that franchisee could legally sell training courses and instruction through failure to fulfill necessary conditions precedent to franchisee's obtaining state license to conduct such a business). See also RESTATEMENT OF CONTRACTS § 599(a) (1932) (*cf. Illus. 3*); 5 S. WILLISTON, CONTRACTS § 1293, at 3683 (1937 ed.).

ity of product, uniformity of identification and distribution, and building the acceptance of a product across the country.<sup>56</sup>

It might also be noted that as a result of the puffing in much of the franchise literature, a great deal of the conditioning of prospective franchisees has occurred prior to the offering by a specific franchisor.<sup>57</sup>

Perhaps the most common of such misrepresentations is the canard that as compared with the fifty percent or greater "failure rate" of independent businessmen, the rate of franchisee failures is less than ten percent. Although the source of that representation has been established as mythical,<sup>58</sup> it is still being employed by ethical authors.<sup>59</sup> The closest approximation to any justification for such figures emanated from J. F. Atkinson's study, *Franchising: The Odds-on Favorite*, tens of thousands of copies of which have been distributed by the International Franchise Association.<sup>60</sup>

As this author disclosed in his Congressional testimony,<sup>61</sup> that report itself revealed that it was based on arbitrary exclusions and highly selected, rather than random, testing. For example, auto dealers were left out because their investment exceeded \$100,000; this, in spite of the fact that the number of such dealers has diminished from 49,000 at the end of World War II to a present 27,000, disclosing a net annual loss of over 1,000 dealers. Gas station dealers were excluded because they are supposedly only lessees, thus ignoring the annual station loss of from 25% to 40% of the Nation's 225,000 dealers. Actual figures were then obtained from highly selected firms whose reports were used just because they were complete. Even more, the report did not reflect the innumerable cases in which franchisors have hidden the "failures" by buying out at grossly depressed prices, frequently less than 10% of the original cash investment.<sup>62</sup>

Far more devastating was the criticism of Atkinson's study by the authors of the SBA-sponsored report, *The Economic Effects of Franchis-*

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<sup>56</sup> From statement of John Y. Brown, President of Kentucky Fried Chicken, January 20, 1970, 1970 *Hearings*, *supra* note 5, at 192.

<sup>57</sup> See note 4 *supra*. See also Note, "Corrective Advertising" Orders of the Federal Trade Commission, 85 HARV. L. REV. 477, 493-94 (1971) for discussion of problems of "residual deception," wherein the effects of such misinformation continue long after the specific falsity has ended.

<sup>58</sup> Levy, *So You Want to Run a Franchise*, DUN'S REVIEW, January 1969, in which the author established that no one could find the source of such statistics.

<sup>59</sup> E.g. Olney, *Beaten Path or Golden Highway*, ELK MAGAZINE, January 1972, at 11.

<sup>60</sup> Because of the on-going activity of the IFA, the FTC might well consider the advisability of a "corrective" order based on the extensive distribution of that book. The IFA has said that it has terminated further distribution of the book. See discussion accompanying notes 61-67 *infra*.

<sup>61</sup> See 1970 *Hearings*, *supra* note 13, at 3-4.

<sup>62</sup> *Id.* at 3-4, 49-52 (including Mr. Atkinson's reactions to these contentions when presented by the author to the Senate Subcommittee).



ing.<sup>63</sup> It there appeared that Atkinson was comparing "failure rates" with "turnovers." Since "turnovers" include the sale, transfer, or closing for any reason whatsoever,<sup>64</sup> obviously the rate of "turnovers" would far exceed the rate of "failures." But the second basis for the Atkinson findings was a glaring misinterpretation of a 1967 Dun and Bradstreet report showing that "of the retail firms that fail," 66% fail within five years,<sup>65</sup> a statement quite different from Atkinson's report that this showed that 66% of all independent businessmen failed within five years.<sup>66</sup> Such "grossly inaccurate data on failure rates" led to the express recommendation that the IFA withdraw Atkinson's book from circulation as it "would be very misleading to potential franchisees."<sup>67</sup>

Most franchisors are more specific with regard to earnings potential, ranging from the actual advertisement by a major oil company as to "the high profit potential" of a specific station with an actual record of endless failures, to the dollar and cents, itemized profit and loss projections offered by major auto factories<sup>68</sup> and numerous service franchisors. Focusing on the trilogy of such typical projections, the SBA study noted

<sup>63</sup> See note 7 *supra*.

<sup>64</sup> The word "turnover" even includes the transfer of an individual proprietorship to one's own corporation.

<sup>65</sup> FAILURE RECORD THROUGH 1969 (Dun & Bradstreet, 1969) at 7.

<sup>66</sup> ECONOMIC EFFECTS OF FRANCHISING, *supra* note 6, at 93-98.

<sup>67</sup> *Id.* at 66.

<sup>68</sup> See legislative statement of Ontario Retail Gasoline Dealers Association given in Toronto, Ontario, on January 18, 1971, quoting the May 1, 1970, newspaper advertisement of Texaco, Inc. in the Windsor Star:

This Texaco Service Station Could Be The Income Opportunity You've Been Looking For!

This Texaco Station will offer an excellent opportunity for the man who wants to be in business for himself and *make a good income. Prime location. Our research indicates strong profit potential. Only small investment required.* (emphasis in the original).

In fact, the record for that particular station showed the following:

<i>Name of Lessee</i>	<i>Date In</i>	<i>Date Out</i>	<i>Time in Business</i>
Denomme		Dec., 1959	
Wright	Dec., 1959	May, 1960	5 mo.
Indig	May, 1960	Mar., 1963	34 mo.
Dingwall	Apr., 1963	Mar., 1965	23 mo.
Plumb	Mar., 1965	Apr., 1965	1 mo.
Grouleau	June, 1965	Apr., 1970	58 mos.

The last dealer is in bankruptcy.

The conclusion drawn by ORGA was:

Not only should the Federal Consumer and Corporate Affairs Department prosecute for misleading advertising, but the lessees who were enticed to invest their life savings in this "DOG" of a station, should have the right to sue the oil company for triple damages, for their failure to disclose complete truthful information about past and potential profit potential.

*Id.* As for the auto manufacturers, their income projections for "dealer development" dealers can hardly be defended against a record of far more than fifty percent in failures, often with repeated failures at the same location. Even worse, it has been charged that such failures are

the natural tendency for potential franchisees . . . to interpret the smallest income level to be a 'minimum expected,' the middle income to be an 'average expected,' and the largest to be a 'maximum' expected.<sup>69</sup>

Based on figures from 67 fast food franchise systems, including many of the large, better-known franchisors, the actual records showed that 72.5% of the franchisees earned less than the minimum, 91.8% earned less than the average, and 98.5% earned less than the maximum. In fact, the franchisee's "family income," including a weekly average of 60 hours of work for the owner, 35 hours for the owner's spouse and 25 hours for each of his two children remained exceedingly low. In 1969, over 10% were existing at a semi-poverty level of less than \$5,000, and that over 25% made less than \$10,000.<sup>70</sup> No one has been able to compute the havoc among franchisees caused by the estimated failure of more than 50% of the fast food franchisors in 1970-71.<sup>71</sup>

As for the specific figures, entries, and footnotes in such pro forma statements, only a highly knowledgeable expert could begin to decipher the caveats and pitfalls. In almost every instance, the exceptions and qualifications, hidden in technical entries and displaced notes, are sufficient to sap any genuine meaning from statements which are obviously intended to lay the basis for an "investment judgment" by the prospective franchisee.<sup>72</sup> But while such dissemblance may appear defensible, there can be no questioning of the use of a pro forma statement showing weekly gross receipts of \$5,000 when the highest record for a specific location has averaged half that amount, with similar comment for gross disparity in figures for rent, advertising, and other crucial entries. For example, "salary expense" which fails to reflect the nonpayment of wages to a prior franchisee's spouse and children, is plainly fraudulent. Equal-

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the predictable result of factory pressure for market penetration regardless of effect on retail profits. See *Bill of Rights*, *supra* note 25, at 770-71. See also \$5.6 million verdict in *Rea v. Ford Motor Co.*, 5 TRADE REG. REP. ¶ 74,015 (W.D. Pa. May 27, 1972); *Wall Street J.*, May 30, 1972, p. 12, col. 2 (primary charge against auto factory based on the theory that destructive competition from such company dominated retail loss operations).

<sup>69</sup> ECONOMIC EFFECTS OF FRANCHISING, *supra* note 7, at 2-12-3; *Barton's Candy Corp.*, 3 TRADE REG. REP. ¶ 19,554 (F.T.C. 1971).

<sup>70</sup> ECONOMIC EFFECTS OF FRANCHISING, *supra* note 7, at 2-13, 5-2.

<sup>71</sup> Although this is the author's own approximation, see *id.* at 2-5, reporting that in the two year period, 1969-1970, there were identified 54 fast-food franchise systems that failed, with the comment that there may have been double or triple that number, it being impossible to meet the challenge of locating non-existent firms. According to numerous reports in *Nation's Restaurant News*, the number increased so severely in 1971 that such reports were no longer newsworthy. A professional franchise consultant reported, "Some of my franchise system clients turn up their toes so fast, I have difficulty keeping track of them." *Id.*

<sup>72</sup> "In almost every instance, the franchise offering literature was either inadequate, misleading, wholly lacking, or blatantly false as to material facts necessary to make an intelligent investment decision." Statement by New York Attorney General Lefkowitz to Committee on Franchise Licensing of the New York Legislature, Sept. 28, 1970. See also Staff Report on Franchising to New York Attorney General, January 7, 1970, reprinted in H. BROWN, *supra* note 12, at 191. While there has been a sharp increase in mail fraud prosecutions in franchise sales, there is no record of prosecutions for larceny by false pretenses.

ly deceptive are figures based on nonexistent pilot operations, on locations patently superior to those newly available or to other exceptional, nonrecurring, or atypical factors.<sup>73</sup> But since financial statements are only the digested compound of numerous operating items, it may be productive to examine some of those principal elements.

Perhaps the widest area of concealment prevails in the realm of kickbacks obtained by the franchisor from third party vendors,<sup>74</sup> as well as in the exorbitant profit on products and services sold to the franchisees. While "kickbacks" have been widely found in fast-food franchising, it is erroneous to charge all such larceny to the newcomers when litigation has fully established that even major oil companies indulged.<sup>75</sup> As for exorbitant profits on products which the franchisees are compelled to buy from the franchisor, recent cases have disclosed a charge of \$21.50 for a spice package costing \$3.00,<sup>76</sup> a chicken dip for \$7.45 that cost \$2.00,<sup>77</sup> and \$4.50 for a gallon of cherries costing \$1.50.<sup>78</sup> But such charges pale by comparison with mark-ups allegedly as high as one thousand percent for so-called "captive" repair parts which auto dealers must buy from the factories in the so-called after-market.<sup>79</sup> When all such concealed payments are added to the initial capital charges and the customary royalty either on gross sales or comparable formula, it may be marvelled that the franchisee can survive at all. In far too many cases, such viability is dependent on endless hours of work or outside supplemental activity, with failure as the alternative.<sup>80</sup> Regardless of the type of fraud on which liability may be based, it is obviously in this area that the greatest

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<sup>73</sup> Throughout this text are illustrations of actual practices disclosed to the author. While documentation has been attempted wherever possible, in many instances such proof is not publicly available.

<sup>74</sup> *Barton's Candy Corp.*, 3 TRADE REG. REP. ¶ 19,554 (F.T.C. 1971).

<sup>75</sup> See, e.g., *Atlantic Refining Co. v. FTC*, 381 U.S. 357 (1965) (commissions obtained from third party vendors of tires, batteries, and accessories); *FTC v. Texaco Inc.*, 393 U.S. 223 (1968) (commissions from third party vendors prohibited even in absence of overt coercion, since the dominant economic power of the manufacturer is "inherently coercive"); *Simpson v. Union Oil Co.*, 377 U.S. 13 (1964); *Shell Oil Co. v. FTC*, 360 F.2d 470 (5th Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967).

<sup>76</sup> See defendant's deposition in *Klinzing v. Shakey's Inc.*, 49 F.R.D. 32 (E.D. Wis. 1970) (notation of allowance of franchisor's counterclaim).

<sup>77</sup> This allegation has been made in *G & K Foods, Inc. v. Kentucky Fried Chicken, Inc.*, No. 71-5 Civ. Ft. M. (M.D. Fla. 1972).

<sup>78</sup> This allegation was made in an antitrust suit against *Howard Johnson & Co.*

<sup>79</sup> This allegation has been made in the pending case of *DiCostanzo v. Chrysler Corp.*, Civ. No. 70-3331, (E.D. Pa., filed Dec. 3, 1970). In *Ford Motor Co. v. United States*, 405 U.S. 562 (1972), the Supreme Court noted that spark plug manufacturers would sell original equipment to auto factories at or below cost in order to benefit from the lucrative "after-market" for replacements based on the almost universal practice of mechanics to use identical makes in repair and maintenance work.

<sup>80</sup> Personal reports to the author have disclosed that six and seven day workweeks, with fifteen hour days, are practically standard in numerous franchise systems, especially in fast-food restaurants, convenient food markets and gasoline service stations. In the latter, all major oil companies vigorously press for 24 hour—7 day station openings, with the operator usually having to handle the better part of the burden.

damages occur. When considered in the light of the usual pro forma financial statements, actual concealment could easily be found.

Fundamentally, the franchisor represents that it has formulated an overall system which will function at least reasonably well under normal circumstances, although many franchisors literally profess to have developed systems with superior performance probabilities. The composite of such a package would clearly include purchasing, merchandising, advertising, sales, record keeping, maintenance, supply and all service matters. Perhaps the principal element would relate to the human factor, based on the representation that "no experience is required," thus calling for superior training, supervision, operating manuals, and expert services. Any material deficiency in such factors would clearly satisfy the requirements of fraud, yet the fleeting quality of such intangible factors could make the problem of proof almost insuperable for the individual franchisee relying on his isolated experience.

Nevertheless, isolated factors may be amenable to objective testing. For example, most franchisors require the allocation of specific funds for advertising, usually based on a percentage of gross sales. Where the franchisor handles such funds, particularly for national or regional programs, the author has urged that the franchisor should be strictly accountable for its handling of the fund, barring its use for advertising for more franchisees, or to subsidize executive salaries, or to cover miscellaneous travel and personal expenses. Such practices would also appear to ground a claim of misrepresentation at the very inception.

Comparably, if training procedures are brief, ill-conceived, and addressed to only ministerial matters, similar complaint is available. Supervisors selected without regard to talent and experience, surveillance that descends to bill collection as its principal function, and a manual of operations copied from an outside system,—all such deficiencies may not only destroy the system, but easily satisfy a fraud charge. Deficient though they may be, it must be recognized that proof of their inadequacy must in the first instance come from the very franchisee who is, by assumption, wholly unknowledgeable. With no certifying authority or other independent source of verification, proof can be virtually impossible.

The more tangible matters will revolve about the actual products which are provided for distribution in some franchise systems. Clearly the franchisor must be answerable for any misrepresentation concerning the design, engineering, manufacture, and functioning of the product, its accessories, and repair parts. The simplicity of such an obvious truth unfortunately conceals the almost universal fact that once the franchisee has been entrapped into the system, he is virtually helpless to complain

about product deficiency, perhaps the most talked about example being in the automotive field.<sup>81</sup>

Closely related to the product itself are a whole array of anticompetitive market practices such as resale price maintenance, territorial or customer allocation, the quota system, full line forcing, tying sales, exclusive supply, and boycott, the opportunity for each of which is especially available in the franchise method of distribution.<sup>82</sup> Wholly aside from a far-reaching groundswell of antitrust litigation to curb such abuses, the very existence of any of such illegal activities would appear to ground a claim of misrepresentation as to the system originally sold to the franchisee.<sup>83</sup>

As to each of these operating factors, it should be evident that fraud is hardly confined to inceptive misrepresentations, particularly when the opportunity to trick or deceive the franchisee actually accelerates after the local store becomes well established. For example, in spite of a whole array of decisions prohibiting the major oil companies from inducing their dealers to purchase specified TBA, particularly through the tying pres-

<sup>81</sup> See *Bill of Rights*, *supra* note 25, at 807-10.

<sup>82</sup> The range of potential antitrust violations is quite extensive, with most of them based on unlawful treatment of the franchisee. See *Perkins v. Standard Oil Co.*, 395 U.S. 642 (1969) (liability through several corporate distribution levels for damages caused by price discrimination); *Fortner Enterprises v. United States Steel Corp.*, 394 U.S. 495 (1969) (extension of credit as tying product); *FTC v. Texaco Inc.*, 393 U.S. 223 (1968) (use of dominant economic power to encourage sale of one brand of tires, batteries, and accessories constitutes an unfair method of competition, even if overt coercive practices are not employed); *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968) (unclean hands no defense); *FTC v. Fred Meyer, Inc.*, 390 U.S. 341 (1968) (price discrimination plan under which retailers could not obtain same quantity discounts as wholesaler-retailer); *Albrecht v. Herald Co.*, 390 U.S. 145 (1968) (fixing maximum prices as an illegal restraint of trade); *United States v. Arnold, Schwinn and Co.*, 388 U.S. 365 (1967) (imposition of customer or territorial restraints on alienation of goods purchased by dealers as per se violation); *United States v. Sealy, Inc.*, 388 U.S. 350 (1967) (horizontal and vertical territorial limitations); *FTC v. Brown Shoe Co.*, 384 U.S. 316 (1966) (incipient violation by major manufacturer in requiring preferential purchase of its goods by dealers); *United States v. General Motors Corp.*, 384 U.S. 127 (1966) (combination of factory and dealers in restraint of trade); *Atlantic Refining Co. v. FTC*, 381 U.S. 357 (1965) (kickbacks obtained from third party vendor of tires, batteries, and accessories); *Klor's, Inc. v. Broadway-Hale Stores, Inc.*, 359 U.S. 207 (1959) (limited boycott by wholesaler); *Semmes Motors' Inc. v. Ford Motor Co.*, 429 F.2d 1197 (2d Cir. 1970) (because of uniqueness of the franchise as an asset, issuance of temporary injunction against termination of a franchise does not depend on franchisee's demonstration of probable success in obtaining a permanent injunction); *Susser v. Carvel Corp.*, 332 F.2d 505 (2d Cir. 1964), *petition for cert. dismissed*, 381 U.S. 125 (1965) (franchisor's exclusive supply arrangement might not be a per se violation when used narrowly to protect trademark); *Siegel v. Chicken Delight, Inc.*, 311 F. Supp. 847 (N.D. Cal. 1970), *aff'd*, 448 F.2d 43 (9th Cir. 1971), except as to evaluation of license fee, *cert. denied*, 405 U.S. 955 (1972) (franchisor failed to carry burden of proving that specifications for a substitute for the tied product would be too complex to be practical). See also proposed FTC complaint in *Chock Full O' Nuts Corp.*, 3 TRADE REG. REP. ¶ 19,846 (F.T.C. 1971) (fast-food franchise allegations of resale price maintenance, tying sales, and exclusive supply).

<sup>83</sup> *Barton's Candy Corp.*, 3 TRADE REG. REP. ¶¶ 19,554, 19,609, 19,786 (F.T.C. 1971) (deception of prospective franchisees as to profitability, site selection, and equipment kickbacks, together with resale price maintenance based on loss of fair trade exemptions by direct competition).

sure of a short term lease,<sup>84</sup> a major oil company inveigled an established gasoline station operator to purchase twenty thousand dollars worth of TBA so that he could supposedly obtain a fifteen percent commission as a warehouseman for the oil company. Unfortunately, not a single sale was made by the oil company to any other retailer, leaving the "warehouseman" with his entire inventory. Because it is reasonable to assume that such tactics are not isolated, it could be shown that the major oil company indulged in what should well be labelled a racket, let alone a fraud.

In another illustration, some franchisors allow franchisees to acquire a franchise with only a small deposit, the balance to be paid by transmitting all of the gross sales to the franchisor, with the crediting of the entire net profit toward the remainder of the franchise fee. If the franchisee should be successful, then he is certain to reach an impasse for lack of funds to pay his own income taxes. Although that incredible ploy has been utilized by a major convenient food market franchisor as well as by a large fast-food franchisor, the latter achieved the ultimate in brazenry in accusing its hapless franchisee of grand larceny for failing to ring in the funds which he needed in order to pay the government, though it was obviously impossible for him to steal his own money.

Perhaps the worst pressure on a franchisee occurs when the very system adopted by the franchisor constitutes a fraud on the ultimate customer, with the franchisee compelled to follow the system for fear of suffering a termination of the franchise. While that very situation occurred with an auto transmission franchisor, whose policy included such programs as customer deception concerning the free reassembling of a transmission if no sale were made, as well as nondisclosure that used parts might be used for repairs,<sup>85</sup> the plight of the franchisee was completely ignored.

Before closing this categorization of operating frauds, brief mention should be made concerning so-called area franchisors, referring to those to whom the franchisor has granted territorial rights to sell franchises to others. In such an arrangement, the area franchisor is usually required to have one of his own operating franchises and subscribes to a quota for the sale of other franchises over a period of a few years. In most cases, he may have some supervisory duties, and he shares in the income re-

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<sup>84</sup> See cases cited note 75 *supra*.

<sup>85</sup> *Aamco Automatic Transmissions, Inc.*, 3 TRADE REG. REP. ¶¶ 19,283, 19,425 (F.T.C. 1971); *H & R. Block, Inc.*, 3 TRADE REG. REP. ¶¶ 19,677, 19,883, 19,949 (F.T.C. 1972) (prohibiting tax return preparation service from misrepresentations regarding reimbursement of customers and legal representation in case of errors, together with unauthorized use of customer information). See also *International Business Coordinators, Inc. v. Aamco Automatic Transmissions, Inc.*, 5 TRADE REG. REP. ¶ 73,772 (S.D.N.Y. 1971) (motion for summary judgment denied, franchisee claiming that he was forced out of business because of his refusal to engage in franchisor's deceptive business practices).

ceived from his sub-franchisees. Although such area franchisors are usually considered part of the management team, they are frequently the object of fraud by the franchisor.

Basically, they are no different from the middlemen in the so-called "pyramid schemes," where there are usually several levels of distributorships with the principal effort devoted to the sale of more sub-distributorships and only incidentally to the warehousing of the product to meet the needs of those in the lower echelons. It has now been widely acknowledged that such programs are implicitly fraudulent because they rely on an endless supply of subdistributors, whereas it is a mathematical certainty that the number of available purchasers will quickly be exhausted and the whole scheme will thereupon collapse.<sup>86</sup>

In substance, the area franchisor is in a similar position since it is implied that he will be able to sustain the program, whereas his chances of success are quite minimal. Upon failure to meet the quota, his investment and on-going income from previous sales are subject to forfeiture. While a few area franchisors may have succeeded because they had the necessary talent and because they entered the game at an early stage, for the most part they have suffered grievous losses.

In each case, what has finally come to be recognized as an intricate fraud in the area of pyramid sales<sup>87</sup> would appear equally applicable to the area franchisor. And it would appear that each of the categories of fraud previously discussed with regard to franchisees, should apply to area franchisors with equal or greater force. Because in most cases the area franchisor would be jointly and severally liable to the franchisee for fraud or other illegal acts, specifically including numerous antitrust violations, the area franchisor is exposed to extensive liability originating from the franchisor, rather than from himself. Though somewhat novel, it would seem that the franchisor should be answerable to the area franchisor under an implicit representation that the area franchise is not the progenitor of tortious liability to others. Regrettably, such pressures on the area franchisor only serve to exacerbate his dissemblance of prospective franchisees.

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<sup>86</sup> See Securities Act of 1933, Release No. 5211, and Securities Exchange Act of 1934, Release No. 9387, both released as a single document on November 30, 1972.

<sup>87</sup> Florida Discount Centers, Inc. v. Antinori, 232 So. 2d 17 (Fla. 1970); Commissioner of Securities v. Hawaii Mkt. Center, Inc., 485 P.2d 105 (Hawaii 1971). See also SEC Releases, *supra* note 86, describing the method in which such pyramid sale and multi-level distribution schemes often constitute "implicit fraud." While some initial state effort to control pyramiding was frustrated; see Koscor Interplanetary, Inc. v. King, 452 S.W.2d 531 (Tex. Cir. App. 1970) more than half the states are vigorously attacking it both through litigation (Massachusetts v. Koscor Interplanetary, Inc., Suffolk Superior Court, Equity No. 93,783 (Mass. 1971) (consent decree for restitution) and legislation, MASS. ANN. LAWS ch. 93, § 69 (Supp. 1971). Iowa was the tenth state to bar pyramid sale schemes by statute (National Observer, December 4, 1971, p. 9, col. 1). See also Note, *Dare to be Great, Inc.: A Case Study of Regulation of Pyramid Sales Plans*, 33 OHIO ST. L.J. 676 (1972).

### C. *Methods of Operation*

Franchisors insist that they must retain quality control over products and services not only to meet their legal obligations under the Lanham Act on threat of losing their trademark,<sup>88</sup> but also as a matter of economic necessity in order to benefit the entire enterprise. It is therefore crucial to understand the methods of operation that prevail in the particular franchise system, in order to evaluate them under the rules governing fraud and full disclosure.

Perhaps the universal common denominator revolves around record keeping and inspection arrangements. These may range from merely providing the franchisee with a set of books to maintain, with a modicum of reporting to the franchisor, through a whole range of increasing intensity. The franchisee may be compelled to use prescribed forms, to transmit them periodically, to provide audited returns, to permit total inspection of all records, and to use cash registers with tamper-proof mechanisms for "gross sales" totals and to submit to physical inspections often without warning. The franchisor may offer to provide minimal or complete bookkeeping and accounting services or the franchisees may be compelled to subscribe to such services and to convey all records to the franchisor. While access to such confidential data and operations may import many other legal responsibilities,<sup>89</sup> the immediate concern is the extent to which they either ground a fraud claim or constitute an integral weapon for its perpetration.

While such information can legitimately be employed to assist the franchisee in controlling his operations, particularly with the use of sophisticated computerized accounting services, it is also readily available to police every aspect of the many matters of economic interest to the franchisor. This would not only include such basic factors as "gross sales" figures for use in computing the royalty, advertising contribution, and lease add-on, all of which are usually prescribed as a percentage of gross sales, but more particularly in support of the numerous anticompetitive practices previously noted. This would include surveillance of prices charged to customers, the identification of all vendors of products and services together with the specific products, prices, and amounts purchased; the identification of all customers, inventory records for new products as well as accessories, replacements, and repair parts, advertising, and both general and specific profit and net worth data. Obviously, such records can be crucial for policing of resale prices, tying sales, territorial or customer restrictions, full line forcing, quotas, and other per se

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<sup>88</sup> See notes 17 and 18 *supra*.

<sup>89</sup> *Milsen Co. v. Southland Corp.*, 454 F.2d 363 (7th Cir. 1971) (record keeping services may be primarily for the franchisor's benefit); see *Fiduciary*, *supra* note 22, at 655, suggesting that access to intimate and confidential records may materially contribute to the recognition of the franchisor's fiduciary obligations.



antitrust violations. The confidential information can also be abused in connection with the franchisor's reacquisition program, its market restructuring,<sup>90</sup> and even for direct competition with the franchisees through company stores.<sup>91</sup> In barest terms, such services can be used simply as another tied product, possibly even at a saving for the franchisee, though as a very profitable matter for the franchisor because of its access to computer services.

Such records can also be used for bruising tactics. For example, until exposed in 1970, the Big Three auto factories used the prescribed profit and loss forms to "prove" that auto dealers were making a profit on the \$6.50 per hour labor rate for which they were reimbursed by the factories for warranty work.<sup>92</sup> Ultimately, independent studies showed that dealers' costs ranged as high as \$11.50 or more an hour and surveys by the factories themselves ultimately proved that the dealers were correct.<sup>93</sup> In the raging controversy, it was hardly mentioned that the profit and loss forms prescribed by the auto factories had apparently been deliberately designed to miscalculate the dealer's labor costs in favor of the factory.

More recently, it has been alleged that one of the Big Three, as well as a major convenient food market franchisor, have deliberately manipulated their dealers' financial returns in order to terminate dealerships and to confiscate the dealers' interest in the business. The auto factory has allegedly done this by manipulating the values of new and used car inventory of so-called minority interest dealers, in order to show that the value of their stock equity has been wiped out.<sup>94</sup> In the convenient mart system, the process has been to devalue the dealer's inventory to such an extent that it goes below the outstanding loan for which it is pledged as security, thus purporting to allow the franchisor to declare a default and to evict the franchisee on less than five minutes' notice.<sup>95</sup>

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<sup>90</sup> See *Bill of Rights*, *supra* note 25, at 768-69.

<sup>91</sup> See E. AYRES, WHAT'S GOOD FOR GM 129-30 (1970).

<sup>92</sup> See *Bill of Rights*, *supra* note 25, at 761-63.

<sup>93</sup> *Id.* at 761n.16.

<sup>94</sup> See, e.g., *Di Costanzo v. Chrysler Corp.*, Civil No. 70-3331 (E.D. Pa., filed Dec. 3, 1970).

<sup>95</sup> The normal mortgage requirements of notice, public advertisement, public auction, acquisition by mortgagee, "chilling" of the bidding, and accounting for any surplus are completely foreign to franchise practices. See UCC requirements for foreclosure of security interests in personal property, UNIFORM COMMERCIAL CODE § 9-504, particularly that "the method, manner, time, place and terms must be commercially reasonable." See also *Keene Lumber Co. v. Leventhal*, 165 F.2d 815 (1st Cir. 1948) (tort of wrongful interference with advantageous relations arising out of abuse in mortgage foreclosure). On a different tack, query whether the self-help termination procedures of franchisors may be a denial of due process under the fourteenth amendment. See *Sniadach v. Family Fin. Corp.*, 395 U.S. 337 (1969) (lack of due process in wage garnishment prior to court hearing); *Fuentes v. Shevin*, — U.S. —, 92 S. Ct. —, 32 L. Ed. 2d 556 (1972), which held unconstitutional a typical state repossession law allowing forcible entry and taking, based solely on creditor's statement of nonpayment, in spite of debtor's claim of a meritorious defense. The decision also denied that there can be a con-

Given the wide panorama of franchisor benefits available because of such record systems, the usual franchisor representations concerning the advantages accruing to the franchisee could easily be false. But, in any case, such statements obviously are used to conceal the true import of such record systems, particularly as a tool for illegal anticompetitive practices.<sup>96</sup> Because of the on-going abuse of such procedures, this should also highlight the prevalence of fraudulent activity after the initial grant of the franchise.

Perhaps the most effective control of franchisees emanates from the terrifying impact of the mere threat of termination of the franchise. While most franchisors require a capital payment for the franchise for its profit value and as a source of capital, even in the absence of such uses, the franchisee's investment would fulfill its prime function as the anchor for the threat of termination. While that investment may well represent the franchisee's life-savings or even family borrowing, a comparable input derives from the "sweat" equity in the franchise where no capital charge is made, but the franchisee devotes his time and effort to develop his dealership.<sup>97</sup>

By couching the franchise in terms of an embellished license, terminable either at will, after a brief tenure, or for violation of a long list of covenants veritably impossible to attain and conditions that are subject to the franchisor's subjective judgment, the franchisor almost always has available the power to terminate the franchise. Just for basics, the franchisor almost always reserves to his sole judgment such matters as prices to the franchisees, a particularly vicious practice in the case of tied products or services, all methods of operation as expounded either orally or in the manual of operations from time to time, quotas or minimum sales requirements, all advertising, maintenance, and refurbishing of the premises; assignments, transfers, and renewals, and the grant of compet-

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tractual waiver of constitutional rights when there is a gross imbalance of power between contracting parties; see also *Lapraese v. Raymours Furniture Co.*, 315 F. Supp. 716 (N.D.N.Y. 1970); Note, *Some Implications of Sniadach*, 70 COLUM. L. REV. 942 (1970). See generally Comment, *Non-judicial Repossession—Reprisal in Need of Reform*, 11 B.C. IND. & COM. L. REV. 435, 440-49 (1970); Brown, *A Meaningful Opportunity to Be Heard*, 46 ST. JOHN'S L. REV. 25 (1971); Note, *Lease Termination and the Use of Summary Dispossess Proceedings to Terminate a Franchise*, 33 OHIO ST. L.J. — (1972).

See reversal of summary finding for convenient food mart franchisor in "unlawful detainer" (*i.e.* eviction) proceeding on ground that in spite of 15 year sublease with 30 day and 24 hour termination clauses, the required existence of a leasing relationship is a factual question to be weighted as against the possibility of a different relationship between the franchisor and franchisee, such as a partnership, or even the existence of the two relationships. *Southland Corp. v. Turnier, et al*, App. Dept., Sup. Ct. Santa Clara County, No. 548 (Calif. 1972).

<sup>96</sup> See note 89 *supra*.

<sup>97</sup> See text accompanying note 13 *supra*. For the administrative expediency involved in diminishing the case load, the California Franchise Investment Act only includes franchises where a capital fee is required. CAL. CORP. CODE § 31005 (Supp. 1972). This provides a ready means of fully avoiding the impact of the statute and perhaps eliminating coverage for over 60 percent of all franchisees, especially for the many product franchises where a capital payment for the license is seldom required.

ing dealerships either for operation as company stores or for sale to independent dealers. As beneficial as some company regulations may be, far too many are impossible to attain, such control often being buttressed by an express covenant that the franchisee will at all times comply with every federal, state, and local law. Some agreements still state that the franchisor shall have the exclusive right to determine whether there has been a default.

Upon such termination, the contract is almost always designed to assure that the franchisee will suffer a loss of all or a major portion of his equity and, universally, that his goodwill will be lost.<sup>98</sup> Even beyond that terrifying prospect, the contract usually contains an extensive covenant barring the franchisee from competing and, in the great majority of cases, conveying to the franchisor control over the site, the telephone listings, and the customer lists. A variation of such terrorizing stems from the frequent use of real or personal property mortgages as an aid to the franchisee's acquisition or operation of the business. In every instance, such major loans provide that they are subject to call on termination of the dealership, thus representing a capital threat not only to the business, but to the franchisee's home as well. The huge deficiencies in such loans are frequently used to induce a quick general release by the franchisee<sup>99</sup> or are then the subject of vigorous state court litigation designed to defeat the franchisee's assertion of his litigational rights.<sup>100</sup>

It had usually been said that such power to terminate was seldom, if ever, actually used except in extreme cases, but that the threat of termination, with dire repercussions, was sufficient to obtain total franchisee supplianee. In fact, experience has shown that some franchisors capriciously toss around such thirty day termination notices not only to dull any incipient independence of a specific franchisee, but also to impress all the other franchisees. Even worse, many individual dealerships are terminated or not renewed solely to gratify an executive's whim, for nepotism, or to dramatically increase the franchisor's gross sales or net profits.<sup>101</sup> As a final blow, the franchisor may just terminate all franchises

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<sup>98</sup> The vice of such capital threat, as well as any restraint on alienation of the franchise, must be evaluated in light of the fact that franchisors are themselves direct competitors in the sale and grant of franchises.

<sup>99</sup> See *Virginia Impression Products Co. v. SCM Corp.*, 448 F.2d 262 (4th Cir. 1971), cert. denied 405 U.S. 936 (1972), in which a terminated distributor who agreed to release with its supplier sought a determination that the release should apply only to claims he intended to release (exclusive of antitrust claims), on same principle that release did not apply to a person not intended to be released. *Zenith Radio Corp. v. Hazeltine Research, Inc.*, 401 U.S. 321, 336 (1971). See also Comment, *Private Antitrust Actions: Limitations and Releases*, 13 B.C. IND. & COM. L. REV. 308 (1971).

<sup>100</sup> See *Milsen Co. v. Southland Corp.*, 454 F.2d 363 (7th Cir. 1971); Brown, note 8 *supra* (growing recognition of litigant's cash flow requirements emanating from first and fourteenth amendments).

<sup>101</sup> See further testimony of John Y. Brown, 1970 *Hearings*, *supra* note 5, at 193-96, providing relevant data on franchisor's greater net profit from reacquired stores than from fran-

and function as a company chain. In the other direction, lesser penalty systems involve fines, company supervisors installed involuntarily, but at the franchisee's expense,<sup>102</sup> or simply reward or harrassment in filling orders or other servicing.

While that entire system, generically characterized as the termination threat, has generally been treated in other contexts, it must also go to the very heart of the fraud issue. Perhaps this may best be illustrated by the statement of a leading franchisor comparing a store manager with a franchisee: as for the manager, as soon as he would achieve competence, he would either want a salary increase, a share of the business, or he would leave for greener pastures; but as for the franchisee, not only had he paid for the right to be a dealer, but he could never leave because he could never come out whole.<sup>103</sup> If the franchisee is thus consigned to a status below that of an indentured servant, then almost all franchise sales literature is grossly fraudulent.

Since friction is almost always to be found in franchising, there has been a modest beginning to find reasonable means of resolution without resort to the potential cataclysm represented by treble damage antitrust litigation in behalf of a class, with damages running into many millions of dollars. While such a noble effort needs encouragement, it is also subject to fraudulent misuse.

Rather than tolerate collective bargaining as a means toward equalization of power,<sup>104</sup> franchisors have sought to employ every "busting" strategy borrowed from the field of labor relations, ranging from simple persuasion to company sponsored councils and from threatened termination for the leaders<sup>105</sup> to favored treatment for the sheep.<sup>106</sup> Misrepresentation of the purpose and efficacy of such procedures abounds in the litera-

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chise royalties or sales of products. See also U.S. DEP'T OF COMMERCE, FRANCHISING IN THE ECONOMY 1969-71 (1971).

<sup>102</sup> See order prohibiting the franchisor's installation of such supervisors unless specifically requested by the franchisee. *In re International House of Pancakes*, 331 F. Supp. 556 (Jud. Pan. Mult. Lit. 1971).

<sup>103</sup> Statement of David Slater, President of Mutual Franchise Corp., Boston Globe, Feb. 18, 1970, at 68, cols. 1-8. He was further quoted, "One of the biggest strengths the franchisor has over the franchisee is the problem of filing a suit under present law. The franchisee can't sue—it costs too much." *Id.*

<sup>104</sup> McGuire, *The Labor Law Aspects of Franchising*, 13 B.C. IND. & COM. L. REV. 215 (1971).

<sup>105</sup> See *In re International House of Pancakes*, 331 F. Supp. 556 (Jud. Pan. Mult. Lit. 1971), which involved a temporary injunction against termination of franchises based upon franchisor's harrassment of leaders of class litigation.

<sup>106</sup> A favorite method of controlling a successful franchisee is to adopt stringent conditions for his qualifying to obtain additional franchises, coupled with the inherent threat of granting a highly competitive site to a stranger. See *Perma Life Nat'l Inc. v. International Parts Corp.*, 392 U.S. 134 (1968).

ture published by the "Big Three" auto factories<sup>107</sup> and is frequently the subject of similar boasting by other franchisors.

Another ploy has been the promotion of arbitration as an established businessman's method of avoiding disastrous litigation, particularly for parties in a continuing relationship. In fact, although the strong public policy behind enforcement of the antitrust laws<sup>108</sup> and the securities acts<sup>109</sup> has precluded the use of such arbitration clauses as a bar to court litigation, the countervailing policy favoring arbitration has been extended even to cover the issue of fraud, at least where the contracting parties had equal bargaining power.<sup>110</sup>

Unfortunately, the principal reason for such arbitration clauses has been to forestall the franchisees' resort to class litigation, particularly under the antitrust laws. The abuse of the arbitration process has sometimes been exacerbated by the franchisor's unilateral designation of the arbitrator and by the usual provision that all arbitration is to take place at the franchisor's home office or other designated location even though it be thousands of miles removed from the franchisee's location.<sup>111</sup>

It may surprise some to know that such patent denial of simple due process of law has been sponsored not by some fly-by-night newcomer, but by the world's largest corporation in its relations with its more than 10,000 auto dealers. While seeking to hide under the cover that such arbitration is binding on the company, but not on the dealer, the franchisor selects and pays the arbitrator<sup>112</sup> and, until goaded into a recent change, all proceedings were conducted at Kansas City, Missouri. The gross impropriety of the franchisor's unilateral selection of the arbitra-

<sup>107</sup> As to an auto dealer's "right of free association" provided in a recently enacted Massachusetts statute, see *Bill of Rights*, *supra* note 25, at 811-16.

<sup>108</sup> *A. & E. Plastik Pak Co. v. Monsanto Co.*, 396 F.2d 710 (9th Cir. 1968). See also *Cobb v. Network Cinema Corp.*, 5 TRADE REG. REP. ¶ 74,011 (N.D. Ga. March 1, 1972) (in anti-trust claims arising from sale and operation of "Jerry Lewis Cinemas," franchisee must continue arbitration where there was "voluntary submission" arising from his incipient participation and filing of a counterclaim).

<sup>109</sup> *Wilko v. Swan*, 346 U.S. 427 (1953).

<sup>110</sup> *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967) (binding at least where contracting parties are of equal bargaining power). See also *Monroe, Commercial Arbitration: A Substitute for Franchise Contract Litigation?*, 26 ARB. J. (n.s.) 147 (1971); *Lifflander, A Proposal for Change*, 5 FRAN. J. 43 (1972). But see enforcement ordered of arbitration agreement for alleged violation of state antitrust law, *N.Y. GEN. BUS. LAW. § 340*, in *Wunsch v. Benco Int'l Importing Corp.*, 5 TRADE REG. REP. (1972 Trade Cas.) ¶ 73,855 (N.Y. Sup. Ct. Feb. 9, 1972). One of the most recent contracts excepts from arbitration the franchisor's claim for money, for eviction, or to protect the trademark; it also prescribes a one year statute of limitations bar for all claims, instead of the four year statute for federal antitrust claims.

<sup>111</sup> See *Milsen Co. v. Southland Corp.*, 454 F.2d 363 (7th Cir. 1971) (critical comment on such an arbitration clause).

<sup>112</sup> See *Bill of Rights*, *supra* note 25, at 774-75. Cf. *MacCaulay, Changing a Continuing Relationship Between a Large Corporation and Those Who Deal With It: Automobile Manufacturers, Their Dealers, and the Legal System*, 1965 WIS. L. REV. 483 (Part I), 740 (Part II); *Hewitt, Termination of Dealer Franchises and the Code—Mixing Classified and Coordinated Uncertainty with Conflict*, 22 BUS. LAW. 1075 (1967).

tor and of his payment by the franchisor is hardly offset by the "one-way" arbitration, the company having declined even to answer an offer of reversing the positions. Even worse, however, the arbitrator has never considered any of the charges of flagrant antitrust abuses by the franchisor. While dealers have been deliberately and fraudulently induced to utilize that "arbitration" procedure rather than resort to court litigation, the company stoutly defends the fact that only one decision has ever been rendered in favor of a franchisee<sup>113</sup> and that the present arbitrator has never so ruled, the expressed reason having been simply stated, namely, "General Motors is always right."

Lest it be thought that others are better, some reference must be made to the supervisory system used by most franchisors for liaison control. Aside from the absence of standards to select such men or to review their decisions, recent disclosures showed a substantial rate of alcoholism, particularly at high levels in the automotive industry, with some district managers being incoherent after their extended luncheons. The second largest auto factory guarantees the result of all conferences between its highly trained executives and the individual dealer by barring any talk whatsoever if the dealer appears with his attorney.

The almost universal representation that the franchisor will support the franchisee with specialists in every field of operation<sup>114</sup> can hardly be squared with systems in which the franchisor is primarily concerned with or even absolutely dependent upon, the sale of the franchises, rather than the marketing of the franchisee's products. Many franchisees have been dismayed to find that every request for expert assistance has concluded with a substantial invoice for services rendered. When asked why the bill should be so high for services of an almost repetitive nature, the franchisors respond with references to their great expertise. In such cases, the franchisee must pay to become a franchisee, pay a royalty to continue as such, and pay a fee for each service rendered.

### III. LEGAL CONCEPTS

#### A. *Common Law*

Given such pervasive factual illustrations of misrepresentation both at the inception and during the franchise relationship, quite possibly the classical rules of deceit would suffice, namely, the intentional misstatement of a material fact on which reliance was meant and with damage thereby caused.<sup>115</sup> Further, the extensive use of such a remedy is not likely to have reached appellate reports, the issue being essentially a question of fact. Nonetheless, since such recourse has apparently done little

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<sup>113</sup> *Bill of Rights*, *supra* note 25, at 774 n.50.

<sup>114</sup> See H. BROWN, *supra* note 12, at 3-5.

<sup>115</sup> See RESTATEMENT OF TORTS § 525 (1938).

to control the excesses of the franchise industry, it would be worthwhile to probe the full extent of common law relief, while recognizing that there is no uniformity in such state regulation.

With the critical importance of assurances in profit projections, it is pertinent to note that usually neither a mere promise nor opinion is acceptable as the factual subject matter of misrepresentation, unless it can be shown that there was never an intention to perform, such an absence of intent being considered factual.<sup>116</sup> In some jurisdictions, however, recovery may be had in a deceit action

by proof of a statement made as of the party's own knowledge, which is false, provided the thing stated is not merely a matter of opinion, estimate, or judgment, but is *susceptible of actual knowledge*; and in such case it is not necessary to make any further proof of an actual intent to deceive.<sup>117</sup>

Carrying that rule a step further, a New Hampshire court has ruled that opinion misrepresentation is actionable where there is special knowledge of complex matters.<sup>118</sup> Such rules would appear equally as far reaching as liability premised on a reckless disregard for the truth or even negligence in the ascertainment of the facts.<sup>119</sup> In such instances, both promises and projections would become actionable.

There has also been considerable pressure to find liability for nondisclosure of material facts. At the half-way point, liability may be found where there has been active concealment by some trickery to prevent discovery of the truth.<sup>120</sup> But it would be far more productive if an affirmative duty of disclosure could be established.<sup>121</sup> In a case premised on the gross disparity in the positions of the parties, a specialist was held

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<sup>116</sup> See, e.g., *Moran v. Levin*, 318 Mass. 770, 64 N.E. 2d 360 (1945).

<sup>117</sup> *Chatham Furnace Co. v. Moffatt*, 147 Mass. 403, 404, 18 N.E. 168, 169 (1888); the rule was most recently applied in *Powell v. Rasmussen*, 355 Mass. 117, 243 N.E.2d 167 (1969). See also *Yorke v. Taylor*, 332 Mass. 368, 124 N.E.2d 912 (1955) (innocent misrepresentation of assessed value of real estate is actionable, it being no defense that a buyer could easily have checked at assessor's office); *Sandler v. Elliott*, 335 Mass. 576, 141 N.E.2d 367 (1957) (plaintiff's lack of diligence no defense to fraud in sale of franchise).

<sup>118</sup> See, e.g., *EnoBrick Corp. v. Barber-Greene Co.*, 109 N.H. 156, 245 A.2d 545 (1968).

<sup>119</sup> *Hanberry v. Hearst Corp.*, 276 Cal. App. 2d 680, 81 Cal. Rptr. 519 (1969) (where magazine publicly represented its guarantee of advertiser's product, it would be liable even though only guilty of negligence in its verification). Cf. *Shemtob v. Shearson, Hammill & Co., Inc.*, 448 F.2d 442 (2d Cir. 1971) (SEC Rule 10b-5 requires intent to defraud or reckless disregard for the truth, and it is insufficient to allege mere negligence).

<sup>120</sup> See *Maxwell v. Ratcliffe*, 356 Mass. 560, 562-63, N.E.2d 250, 252 (1969); "Because the question of the dryness of the cellar had been raised expressly, there was special obligation on the brokers to avoid half truths and to make disclosure at least of any facts known to them or with respect to which they had been put on notice." *Id.*

<sup>121</sup> See *Goodwin v. Agassiz*, 283 Mass. 358, 186 N.E. 659 (1933) (corporate director not liable to stockholder for misrepresentation in purchase of latter's stock through an exchange, where stockholder sold stock on third party information that certain mineral exploration had been terminated, whereas director in fact had the benefit of an expert's contrary opinion); cf. A. BROMBERG, *SECURITIES LAW: FRAUD, SEC RULE 10B-5* § 12.3 (1st ed. 1967) (Rule 10b-5 as a disclosure rule).

liable for dishonest advice in his handling of the patents of an aged inventor, the court ruling,

When confidence is reposed and accepted, the person trusted is liable for expressing dishonest opinions upon which the other party relies and acts to his damage, and he is also liable for concealing facts which by reason of the relationship he should disclose.<sup>122</sup>

Such reasoning would seem applicable in most franchise situations, particularly at the inception.

Carrying that concept further, it has been urged that where there has been abusive self-preference at the very beginning of the franchise relationship, a constructive fraud or quasi-fiduciary relationship can be found in the gross imbalance in the positions of the parties in a complex matter where the franchisee not only reposes his confidence in and displays a willingness to be guided by the franchisor, but the latter usually insists on such a posture.<sup>123</sup> In what has now been recognized as a classical statement in this recently evolving area, it was said:

In redressing an abuse of trust and confidence equity will review such factors as the relation of the parties prior to the incidents complained of, the plaintiff's business capacity or lack of it contrasted with that of the defendant, and the readiness of the plaintiff to follow the defendant's guidance in complicated transactions wherein the defendant has specialized knowledge. Equity will, in sum, weigh whether unjust enrichment results from the relationship.<sup>124</sup>

In the application of such concepts to franchising, an Ontario trial court in fact held that such a quasi-fiduciary relationship did exist, requiring the payment to the franchisees of the secret kickbacks obtained by the franchisor from the third party vendors.<sup>125</sup> While affirming the propriety of the equitable principles involved, the Ontario Supreme Court reversed on the questionable ground that in the particular instance, the necessary gross disparity of the parties was absent. Given the great complexity in the economic misrepresentations involved in franchising, coupled with the severity of the impact on the defrauded franchisee, there would appear to be serious need to provide protection through such imposition of an affirmative duty of disclosure, at least with regard to the areas of most sensitivity to the innocent franchisee.

Closely related to the issue of fraud in the inducement is the trend to

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<sup>122</sup> *Reed v. A. E. Little Co.*, 256 Mass. 442, 449, 152 N.E. 918, 920-21 (1926); *Scott*, TRUSTS § 462.2 (1967); RESTATEMENT OF RESTITUTION § 201 (1937).

<sup>123</sup> *Broomfield v. Kosow*, 349 Mass. 749, 755, 212 N.E.2d 556, 560 (1965); *Meinhard v. Salmon*, 249 N.Y. 458, 467, 164 N.E. 545, 548 (1928); Pound, *Progress of the Law: Equity*, 33 HARV L. REV. 420 (1920); See also Rosenfeld, *Big Brother as a Fiduciary: Suing the Franchisor*, CASE & COMMENT, July-Aug., 1971, at 38.

<sup>124</sup> *Broomfield v. Kosow*, 349 Mass. 749, 755, 212 N.E.2d 556, 560 (1965).

<sup>125</sup> *Jirna Ltd. v. Mister Donut of Canada, Ltd.*, 13 D.L.R.3d 645 (1970) *rev'd on other grounds*, 1 Karas Exec. Rep., No. 14, at 1 (1971).



find implied covenants, conditions, or warranties in every agreement, Professor Williston having simply declared that "in every contract there exists an implied covenant of good faith and fair dealing."<sup>126</sup> While some courts have generally referred to these as necessary implications from the expressed intent of the parties,<sup>127</sup> others have emphatically declared that

[i]n every contract there is an implied covenant that neither party will do anything having the effect of destroying or injuring the right of the other party to receive the fruits of the contract.<sup>128</sup>

Such concepts would not only clearly prohibit all fraud, trickery, and deception after the inception of the franchise relationship, but would lay the basis for an affirmative duty of full disclosure to prevent entrapment.

Of equal importance are various corollaries and procedural matters in which the issue of fraud is or should be of primary consequence. One of these involves the developing law on piercing the corporate veil, under which it is possible to establish financial liability against a parent or related corporation, or even against the individual stockholders. Aside from the antitrust cases,<sup>129</sup> such principles are supported where the corporation is used as a mere agent, where there is general confusion as to the separation of interest, but especially where there are elements of fraud in the corporate maneuvers.<sup>130</sup>

On the question of the burden of proof, possibly because fraud had many of the characteristics of moral turpitude, if not outright criminality, some older cases appeared to indicate that the plaintiff had to satisfy more than the preponderance of proof required in civil matters, a view

<sup>126</sup> WILLISTON, CONTRACTS § 1926 (1936).

<sup>127</sup> See *Motel Managers Training School, Inc. v. Merryfield*, 347 F.2d 27 (9th Cir. 1965) (implied covenant of feasibility in sale of a franchise); *G & K Foods, Inc. v. Kentucky Fried Chicken*, 71-5 Fr. M. (M.D. Fla. 1972) (implied covenant that franchisor won't compete with franchisee); *Burger v. Ray*, 239 S.W. 257, 259 (Tex. Civ. App. 1922); *Cheek v. Metzger*, 116 Tex. 356, 363, 291 S.W. 860, 863 (Tex. Civ. App. 1927); see also *supra* note 55.

<sup>128</sup> *Lutz v. Bayberry*, 148 N.Y.S.2d 762, 767 (Sup. Ct. 1956). Consequently, some courts have prohibited the termination of a franchise before the franchisee has had an opportunity to recoup his investment with a reasonable profit. See also *Gibbs v. Bardahl Oil Co.*, 331 S.W.2d 614 (Mo. 1960); *Beebe v. Columbia Axle Co.*, 233 Mo. App. 212, 117 S.W.2d 624 (1938).

<sup>129</sup> In line with its declared policy of examining the economic realities in antitrust matters, *United States v. Concentrated Phosphate Export Ass'n*, 393 U.S. 199, 208 (1968), the Supreme Court has experienced little difficulty in detecting unfair practices through several levels of distribution, regardless of the degree of corporate ownership. *Perkins v. Standard Oil Co.*, 305 U.S. 642 (1969); *Fison's Limited v. United States*, 5 TRADE REG. REP. ¶ 73,790 (7th Cir. 1971).

<sup>130</sup> See *My Bread Baking Co. v. Cumberland Farms, Inc.*, 353 Mass. 614, 619, 233 N.E.2d 748, 752 (1968). See generally *Centmont Corp. v. Marsch*, 68 F.2d 460, 464 (1st Cir. 1933), *cert. denied*, 291 U.S. 680 (1934); *The Willem Van Driel, Sr. v. Pennsylvania R.R.*, 252 F. 35 (4th Cir. 1918), *cert. denied*, 252 U.S. 584 (1920); H. BALLANTINE, CORPORATIONS §§ 136-38 (rev. ed. 1946); Douglas & Shanks, *Insulation from Liability Through Subsidiary Corporations*, 39 YALE L.J. 193, 195-210 (1929); Comment, *Alternative Methods of Piercing the Corporate Veil in Contract and Tort Cases*, 48 B.U.L. REV. 123 (1968); Note *Liability of a Corporation for Acts of a Subsidiary or Affiliate*, 71 HARV. L. REV. 1122 (1958).

that had no judicial foundation and which is now being avowedly disowned.<sup>131</sup> In a recent class consumer fraud case, the California Supreme Court keenly recognized the impropriety of requiring that the consumer prove the falsity of the seller's representations, ruling that after the consumer had satisfied the burden of coming forward with some proof of misrepresentation, the seller would thereafter bear the burden of proving the truth of its statements.<sup>132</sup> In fact, to the extent that courts may be persuaded to accept the concept of a quasi-fiduciary relationship at the very inception of the franchise and, even more clearly, where fiduciary duties exist thereafter, the franchisor should bear the entire burden of proving the fulfillment of his fiduciary obligations and the legitimacy of any claim he alleges against the franchisee.<sup>133</sup>

Based not only on the franchisor's established superiority, possession, and understanding of all the pertinent data, but also on its actual representation of such expertise as the very justification for the franchising relationship, it should bear both the burden of coming forward and the burden of proof. If these duties appear onerous, their validity would seem self-evident as compared with the imposition on the franchisee of an obligation to prove a whole panorama of negatives, including such matters as a showing that the franchisor's merchandising, training, site location and managerial systems are deficient. To meet such a burden, the franchisee would have to develop all the skills on which the franchisor, itself, induced him to look to it for support. When a major oil company advertises that "our research shows great profit potential for this station," it appears reasonable to require that it affirmatively justify its statement.<sup>134</sup> And where the franchisor advertises for franchisees with "no experience required," it would be offensive to common sense to require such a franchisee to disprove the honesty of the franchisor's express claims. It is not at all unfair that any doubt should be resolved against the omnipotent franchisor, including his proving the propriety of all financial transactions.<sup>135</sup> The latter would appear mandatory where the franchisor actually maintains the franchisee's books of account or deprives the franchisee of essential information.

Intimately related to the burden of proof are all matters concerning the ascertainment and amount of damages. Again, based on the special relationship in franchising, it would seem appropriate to strengthen the usual common law concepts, perhaps under the guidance of rules governing the

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<sup>131</sup> See *Rigot v. Bucci*, 245 So. 2d 51 (Fla. 1971).

<sup>132</sup> *Vasquez v. Super. Ct. of San Joaquin County*, 4 Cal. 3d 800, 484 P.2d 964, 94 Cal. Rptr. 796 (1971).

<sup>133</sup> Cf. RESTATEMENT (SECOND) OF TRUSTS § 172, comment b at 377 (1959).

<sup>134</sup> See legislative report of such an advertisement by Texaco, Inc., note 67 *supra*.

<sup>135</sup> See *Samia v. Central Oil Co.*, 339 Mass. 101, 128, 158 N.E.2d 469, 485 (1959) (corporate directors bear burden of proving propriety of their expense accounts); cf. A. SCOTT, II THE LAW OF TRUSTS § 172, at 1399 (3d ed. 1967).

very antitrust matters with which franchising is so intimately involved. While precluding mere speculation, it would be sufficient to provide computation based on reasonable calculations.<sup>136</sup> Although permitting the franchisor to adduce countervailing explanations for such damages, it should bear the burden of proof on such tangential defenses lest it otherwise be allowed to benefit from its own malfeasance.<sup>137</sup> Similarly, if such pleas as contributory negligence, unclean hands, or equal guilt are given any credence, the franchisor should not only sustain the usual burden of proof for such affirmative defenses, but such matters should only go toward the mitigation of damages. The restrictions on the effect of such defenses would not only be based on public policy, but would also avoid the possible forfeiture of a substantial claim merely because of a minor defense that could be adequately recognized through an offset of its value.<sup>138</sup>

The public policy behind these precepts should stem from the need of strong deterrents against those practices which are employed by the economically strong against those who are innocent and weak. Such preventive measures would be lacking if those with extensive knowledge and means could not only act in self-preference, but also face only the possibility of having to return the loot if the individual franchisee should be able to survive lengthy and expensive litigation at the very time that he is least able to afford it. This very consideration was recently found by the Seventh Circuit Court to be the source of irreparable damage justifying a temporary injunction against termination of the franchisee's business, lest he lose the financial cash flow to sustain the litigation.<sup>139</sup>

Because neither double nor treble nor other punitive damages are generally allowable at common law, it is significant if the franchisor be found in violation of a quasi-fiduciary or actual fiduciary obligation. In either instance, the equitable jurisdiction of the court may be extended far beyond the allowance of the damages directly attributable to the fraud. Under established principles applicable to a fiduciary that indulges in self-preference, the court may reject the allowance of all other compensation no matter how reasonable it may independently have been.<sup>140</sup>

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<sup>136</sup> See *Bigelow v. RKO Radio Pictures, Inc.* 327 U.S. 251, 265 (1946) and an entire line of cases devolving therefrom, discussed in Note, *Private Treble Damage Antitrust Suits: Measure of Damages for Destruction of All or Part of a Business*, 80 HARV. L. REV. 1566, 1572 (1967). See also *Miller v. Commissioner*, 333 F.2d 400 (8th Cir. 1964) (valuation of goodwill a question of fact); *Morton Bldgs. of Nebraska, Inc. v. Morton Bldgs. Inc.*, 333 F. Supp. 187 (D. Neb. 1971).

<sup>137</sup> *Id.*

<sup>138</sup> For comparable antitrust rule based on a weighing of similar equities, see *Perma Life Mufflers, Inc. v. Int'l Parts Corp.*, 392 U.S. 134, 139-40 (1968); *Credit Bureau Reports, Inc. v. Retail Credit Co.*, 5 TRADE REG. REP. ¶ 73,813 (S.D. Tex. 1971).

<sup>139</sup> *Milsen Co. v. Southland Corp.*, 454 F.2d 363 (7th Cir. 1971). See *Brown, A Meaningful Opportunity to be Heard*, 46 ST. JOHN'S L. REV. 25 (1971).

<sup>140</sup> Under such principles, in *Broomfield v. Kosow*, 349 Mass. 749, 212 N.E.2d 556

For example, in addition to ordering the repayment of illegal kickbacks, the court might disallow all royalties on gross sales.

As a further deterrent, such franchisors are confronted with newly developing procedural devices. Under the Federal Rules of Civil Procedure, as well as in many States, the franchisees may now join their claims in a class action, primarily where common questions of fact or law predominate.<sup>141</sup> While the maintenance of franchisee litigation as a class action is now being more generously granted,<sup>142</sup> such progress has not been free from all difficulty, particularly where aspects of fraud may be involved. It has been stated that the propriety of a class action is doubtful when misstatements are oral,<sup>143</sup> particularly where not made pursuant to a common course of conduct and where the issue of reliance by hundreds of plaintiffs might require separate hearings.<sup>144</sup> Such a common nexus could be shown where the representations were from a common source, such as in prospectus-type documents or where based on nondisclosure coupled with an affirmative obligation to disclose.<sup>145</sup> But

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(1965), the court disallowed the \$10,000 fee which the trial court had found was reasonable compensation for the lender-builder's efforts and went even further to assess interest on the judgment at 15 percent per annum since the lender-builder had originally set that high rate of interest.

<sup>141</sup> See FED. R. CIV. P. 23, specifying the various conditions governing such class designation. Unless federal jurisdiction is acquired through pendent jurisdiction with claims under federal law, diversity of citizenship is necessary and each claim must independently achieve the jurisdictional amount of 10,000 dollars. *Snyder v. Harris*, 394 U.S. 332 (1969).

<sup>142</sup> After the first such case, *Siegel v. Chicken Delight, Inc.*, 271 F. Supp. 722 (N.D. Cal. 1967), it was four years before a series of other franchise cases obtained such classification, namely *Abercrombie v. Lum's, Inc.*, C.A. No. 295-70A (E.D. Va. 1971); *In re International House of Pancakes Franchise Litigation*, 331 F. Supp. 556 (W.D. Mo. 1971); and *Butkus v. Chicken Unlimited Enterprises, Inc.* 1971 TRADE CAS. § 73,780, ( D. Ill. 1971).

In a recent acceleration of such decisions, there has been substantial cleavage in district court treatment, with some courts recanting on previously granted certifications. See *McCoy v. Convenient Food Mart, Inc.*, 5 TRADE REG. REP. § 73,873 (D. Neb. 1972) (grant of class status in convenient food market franchise, subsequently suspended and now under reconsideration); *Gaines v. Budget Rent-A-Car Corp. of America*, 5 TRADE REG. REP. § 73,860 (N.D. Ill. 1972) (denial of class status to car rental franchisees on ground of insufficient numbers, lack of predominant questions of fact or law, and potential conflict of interest of a former franchisee); *Free World Foreign Cars, Inc. v. Alfa Romeo, S.P.A.*, 5 TRADE REG. REP. § 73,925 (S.D.N.Y. 1972) (denial of class status where grant would have jeopardized defendants' continued existence, with potential conflict of interest between former and existing dealers). For sharp contrast with such treatment, see *Sunrise Toyota Ltd. v. Toyota Motor Co., Ltd.*, 5 TRADE REG. REP. § 74,092 (S.D.N.Y. 1972) (grant of class to auto dealers for claims of unfair allotment and compulsory advertising contributions under Auto Dealers Day in Court Act); *Merit Motors, Inc. et al v. Chrysler Corporation*, C.A. No. 2000-70 (D. D.C. 1972) (order of July 11, 1972, granting class to auto dealers in claim of price discrimination in sales of autos to major leasing companies); *Seligson v. Plum Tree, Inc. et al*, 5 TRADE REG. REP. § 74,098 (E.D. Pa. 1972) (grant of class to gift shop franchisees for anti-trust claims with pointed criticism of conflict of interest theory); *Lamb v. United Security Life Co.*, 1972 CCH FED. SEC. L. REP. § 93,489 (D. Ia. 1972) (grant of class in security fraud claim with superb discussion of numerous issues).

<sup>143</sup> 6 L. LOSS, *SECURITIES REGULATION* 3947 (2d ed. Supp. 1965), cited with approval in *Morris v. Burchard*, 51 F.R.D. 530 (S.D.N.Y. 1971).

<sup>144</sup> *Morris v. Burchard*, 51 F.R.D. 530 (S.D.N.Y. 1971).

<sup>145</sup> *Id.*; *Cannon v. Texas Gulf Sulfur Co.*, 53 F.R.D. 216 (S.D.N.Y. 1971).

even where the claim is based on oral statements which are admittedly made on many different occasions, such as in the sales talk to various prospective franchisees, the court may well be convinced that such sales talks are usually highly coached, based on a precise list of check-off items and even learned by rote, thus forming a sufficient commonality to warrant class status. Based on such premises, together with the acknowledgment that without the encouragement inherent in such a class grant the rights might not be pursued, the California supreme court recently granted class status in a case involving a scheme for selling refrigerators and frozen food.<sup>146</sup> While many novel issues of manageability and individual proof can arise in class litigation, particularly where oral fraud is involved, it is important to encourage such procedure as a matter of public policy.<sup>147</sup> On one side, the opportunity for substantial recovery may encourage able counsel to undertake such complex litigation on what must of necessity be primarily a contingent fee basis.<sup>148</sup> At the same time, that very exposure to general liability to the entire class of franchisees, rather than to a few claimants, may provide the only ultimate answer to the need for an effective deterrent.

For that very reason, franchisors have adopted extreme measures to prevent the obtaining of such class status. In the first such successful maneuver, when the application for class status came up for hearing, the fast-food franchisor appeared with exclusionary requests by over ninety percent of the franchisees, whereupon class status was denied.<sup>149</sup> No record discloses the basis upon which such statements were procured. On that precedent, other fast-food franchisors have shown comparable alacrity, over one hundred such exclusionary statements having been procured and filed in two separate suits<sup>150</sup> in both of which such highly irregular activity has so far been ignored by the courts. One court has nevertheless granted class status on all issues, including antitrust, fiduciary obligations, and fraud.<sup>151</sup> A significant factor is the general prohibition against the solicitation of members of the putative class by either party,

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<sup>146</sup> *Vasquez v. Super. Ct. of San Joaquin County*, 4 Cal. 3d 800, 484 P.2d 964, 94 Cal. Rptr. 796 (1971) (consumer fraud class suit based on oral sales talk "usually memorized").

<sup>147</sup> See *White, J. in Hawaii v. Standard Oil Co. of Calif.*, — U.S. —, 40 L.W. 4246, 4250 (1972), in commenting on the district court's dismissal of state's class action as being too unwieldy, but denying that such a suit could never be brought, "Rule 23 . . . provides for class actions which may enhance the efficacy of private actions by permitting citizens to combine their limited resources to achieve a more powerful litigation posture." *Id.*

<sup>148</sup> 40 U.S.L.W. at 4248. See *Lamb v. United Security Life Co.*, (S.D. Ia. 1972) 1972 CCH FED. SEC. L. REP. ¶ 93,489 (grant of class status in security fraud case, including a superb analysis of such issues as commonality, numerosity, conflict of interest, evidentiary hearing, and cost of notice).

<sup>149</sup> *Van Landingham v. Denny's Inc.*, C.A. No. 69-424 (D. Ore., filed Nov. 7, 1969).

<sup>150</sup> *In re Int'l House of Pancakes*, 331 F. Supp. 556 (W.D. Mo. 1972); see also *G & K Foods, Inc. v. Kentucky Fried Chicken*, 71-5 Ft. M. (M.D. Fla. 1971).

<sup>151</sup> See *In re Int'l House of Pancakes*, 331 F. Supp. 556, (W.D. Mo. 1972); See also *McCoy v. Convenient Food Mart. Inc.*, 5 TRADE REG. REP. ¶ 73,873 (D. Neb. 1972).

either based on the local rule or the recommended order,<sup>152</sup> including an express caveat against any misrepresentation of the issues to the franchisees. Given the complex nature of most franchise litigation, it is almost inconceivable that a fair representation would be given by a highly involved franchisor. In that frame, it cannot only be expected that the franchisor would exert the full force of its superior economic power, but that it might well distort the basic issues. For example, almost the entire franchise industry has been lecturing franchisees to avoid litigation at all costs because it will necessarily destroy the entire system.

Finally, the place of any trial or arbitration hearing can be of crucial concern to the franchisee, particularly if his dispute is being handled as a singular, rather than class, proceeding. As earlier noted, public policy precludes a contractual arbitration clause from foreclosing resort to a court on antitrust or security matters, yet even the inclusion of fraud as matter for arbitration will be binding, at least where the contracting parties have equal footing.<sup>153</sup> Perhaps this discussion has established the gross imbalance between the contracting parties sufficiently to convince that the issue of fraud is not to be consigned to such arbitration. Further, the usual requirement of a hearing at the franchisor's home office, even though it be thousands of miles away, may itself establish such disparity.<sup>154</sup>

While reference has generally been made to the so-called long-arm statutes under which a local state may obtain jurisdiction over a foreign entity as to any transaction within the state,<sup>155</sup> in the most recent ruling, such jurisdiction has been found to arise even where based solely on the franchisor's "control" over the local distributorship.<sup>156</sup> Where the franchisor attempts to abuse that statute by suing in the forum of its home office, the court may be convinced that the forum is so inconvenient for the franchisee, that it may well amount to a denial of due process because of the franchisee's financial inability to litigate at such a distance. For

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<sup>152</sup> See Manual for Complex and Multidistrict Litigation at 196-97, § 1.61, Suggested Local Rule No. 7, and § 1.62, Sample Pretrial Order No. 15 (rev. ed. 1970). For temporary injunction against franchise termination, see *In re Int'l House of Pancakes*, 331 F. Supp. 556 (W.D. Mo. 1972). See *Weight Watchers of Philadelphia, Inc. v. Weight Watchers Int'l, Inc.* 455 F.2d 770 (2d Cir. 1972) (permitting buy-out discussions in presence of counsel). Such proscription against communication makes a mockery of the suggestion by some courts that class status should be denied because of the absence of intervention by other franchisees; without knowledge of the suit, or perhaps depending on others to bear the burden while they can avoid harassment, active participation of other franchisees is hardly to be expected.

<sup>153</sup> See text accompanying note 130 *supra*.

<sup>154</sup> For a sharp criticism of such a clause, see *Milsen & Co. v. Southland Corp.*, 1971 TRADE CAS. ¶ 73,774 (7th Cir. 1971).

<sup>155</sup> See, e.g., MASS. ANN. LAWS ch. 223A (Supp. 1971); §§ 1-9, Author's Practice Commentary.

<sup>156</sup> *Fisons Ltd. v. United States*, 5 TRADE REG. REP. ¶ 73,790 (7th Cir. 1972). See also *McCoy v. Convenient Food Mart, Inc.*, 5 TRADE REG. REP. ¶ 73,873 (D. Neb. 1972).

that very reason, a court has recently declined to order the transfer of a suit to a distant forum.<sup>157</sup>

### B. Statutory Regulation

There have been numerous efforts to resolve the obvious need for relief against fraud both through litigation<sup>158</sup> and legislation, the latter being premised on the general erosion of such defenses as "seller's talk" or "let the buyer beware" in order to protect those who are economically weak,<sup>159</sup> with a recent acceleration of such trends.<sup>160</sup> Such efforts have also been directed specifically at franchising both at the federal and state levels and in existing and proposed regulations, the scope of which will be briefly reviewed.

Of particular importance in the franchising context is the second aspect of the FTC Act declaring unlawful "unfair or deceptive acts or practices."<sup>161</sup> While in the past this standard has been employed primarily against deceptive advertising of products and services, it has recently been invoked in franchising situations, with particular emphasis on deceptive advertising in the sale of franchises.<sup>162</sup> Premised on the same kind

<sup>157</sup> *Beach v. National Football League*, 331 F. Supp. 249 (S.D.N.Y. 1971).

<sup>158</sup> With regard to the sale of improved realty by the builder-vendor, within the past decade courts in many jurisdictions have expressly ended the application of "caveat emptor" (let the buyer beware) by recognizing an implied warranty of fitness or habitability; see *Theis v. Heuer*, 280 N.E.2d 300 (Ind. 1972), including a summary of such action across the country.

<sup>159</sup> Most states protect consumers in complex matters such as insurance, mortgages, and interest rates, often by prescribing the contracts or subjecting them to approval by regulatory agencies.

<sup>160</sup> E.g., MASS. ANN. LAWS ch. 93 (Supp. 1971); see also such recent amendments as those giving consumers an express cause of action for any violation (§§ 9, 10, adopted in 1969), and ch. 614 of the laws of 1972 granting such a direct cause of action to businessmen in a new § 11. See also MASS. ANN. LAWS ch. 231, § 85 J; Acts 1971, Chapter 450, providing that whoever sells personal property by deceit or fraud shall be liable to a purchaser in tort for treble the amount of the damages sustained. Cf. the absence of a private right of action for compensatory damages for violation of § 5 of the FTC Act, as construed in *Carlson v. Coca Cola Co.*, 318 F. Supp. 785, 786 (N.D. Cal. 1970), citing *Moore v. New York Cotton Exch.*, 270 U.S. 593 (1926), noting several Congressional proposals that would grant such relief, e.g., S. 986 (92d Cong., 1st Sess.), which passed the Senate by a 76-to-2 vote, 544 TRADE REG. REP. 1 (1971) (FTC final order would be prerequisite to consumer suit). For a penetrating analysis of the problems and shortcomings in such federal proposals, see Newberg, *Federal Consumer Class Action Legislation: Making the System Work*, 9 HARV. J. LEGIS. 217 (1972). Although two of the bills would confine relief to consumers, in a third bill "consumer" would be defined to include anyone "who is offered a personal business or moneymaking opportunity." *Id.* at 240 (commenting on the "Eckhardt-Bayh" measure, H.R. 5630, 92nd Cong., 1st Sess. (1971), introduced by Representative Eckhardt on March 4, 1971; and S. 1378, 92d Cong., 1st Sess. (1971), introduced by Senator Bayh on March 24, 1971, as a companion bill to H.R. 5630, § 3(c)).

<sup>161</sup> 15 U.S.C. § 45(a)(1) (1970).

<sup>162</sup> *Meal or Snack System, Inc.*, [1967-1970 Transfer Binder] TRADE REG. REP. ¶ 18,671 (F.T.C. 1969) (consent order to cease and desist arising out of alleged misrepresentation in the sale of fast-food franchises); *Success Motivation Institute, Inc.*, 3 TRADE REG. REP. ¶ 19,306 (F.T.C. 1970) (consent order arising out of alleged misrepresentation in the sale of self-improvement academy franchises); *Universal Credit Acceptance Corp.*, 3 TRADE REG. REP. ¶ 19,371 (FTC 1970) (complaint issued alleging misrepresentation in the sale of a credit

of disclosure required under the Securities Acts, FTC Commissioner MacIntyre has said,

Not only must the franchisor give [to a prospective franchisee] accurate information about his franchise system, but . . . he also has the affirmative duty to reveal any unfavorable news concerning the system.<sup>163</sup>

While endorsing that view, the FTC General Counsel elaborated that such "unfavorable news" includes "pending law suits or FTC actions, or the fact that the franchisor competes in his own system."<sup>164</sup> Unfortunately, such obligations have been totally ignored and, in the absence of a private right of action,<sup>165</sup> franchisors have been subject to no effective compulsion.

In a dramatic recognition of the broad scope of the power of the FTC to enjoin "unfair methods of competition and unfair or deceptive acts or practices,"<sup>166</sup> the Supreme Court has just ruled

that the Federal Trade Commission does not arrogate excessive power to itself if, *in measuring* a practice against the elusive, but congressionally mandated *standard of fairness*, it, *like a court of equity*, considers *public values* beyond simply those enshrined in the letter or encompassed in the spirit of the antitrust laws.<sup>167</sup>

Further, while declining to permit the substitution of a court's evaluation for that of the FTC, Justice White there noted the standards which the FTC itself has described as the factors it considers "in determining whether a practice which is neither in violation of the antitrust laws nor deceptive is nonetheless unfair,"<sup>168</sup> quoting the FTC as follows:

(1) whether the practice, without necessarily having been previously considered unlawful, offends public policy as it has been established by

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card franchising plan); Century Brick Corp. of America, 3 TRADE REG. REP. ¶ 19,391 (FTC 1970) (consent order whereby franchisors of simulated brick and floor covering distributorships were prohibited from recruiting franchisees through misrepresentation).

<sup>163</sup> Address by F.T.C. Commissioner Everett MacIntyre, Conference of International Franchise Assn., May 8, 1969, 5 TRADE REG. REP. ¶ 50,240 (F.T.C. 1970).

<sup>164</sup> 451 CCH TRADE REG. REP. 6, 7 (1970).

<sup>165</sup> See, e.g., *Carlson v. Coca Cola Co.*, 318 F. Supp. 785 (N.D. Cal. 1970), citing *Moore v. New York Cotton Exch.*, 270 U.S. 593 (1926); cf. *Farmington Dowel Prods. Co. v. Forster Mfg. Co.*, 421 F.2d 61 (1st Cir. 1970), cert. denied, 385 U.S. 1003 (1967) (final FTC order in antitrust ruling admissible as prima facie evidence of violation as provided in § 5(a) of the Clayton Act, 15 U.S.C. § 16(a) (1970). *Purex Corp. v. Precter and Gamble Co.*, 5 TRADE REG. REP. ¶ 73,782 (9th Cir. 1971), cert. denied, 405 U.S. 1065 (1972) (under Finality Act, 15 U.S.C. § 21 (1911) and § 5 of the Clayton Act, 15 U.S.C. § 16 (1971), FTC § 7 antimerger order, which merged into a final decree of a court of appeals, may be introduced in subsequent private treble damage litigation to establish a rebuttable presumption of fact; express reservation of whether underlying FTC record could also be used and whether same would apply to FTC order that had not been merged into final court decree).

<sup>166</sup> 15 U.S.C. § 45(a)(1) (1970).

<sup>167</sup> *FTC v. Sperry & Hutchinson Co.*, 405 U.S. 233, 244 (1972); see also Comment, *Section 5 of the Federal Trade Commission Act: A Source of Protection for Competitors and Consumers*, 12 B.C. IND. & COM. L. REV. 982 (1971).

<sup>168</sup> *FTC v. Sperry & Hutchinson Co.*, 405 U.S. 233 (1972).



statutes, the common law, or otherwise—whether, in other words, it is within at least the penumbra of some common-law, statutory, or other established concept of unfairness; (2) whether it is immoral, unethical, oppressive, or unscrupulous; (3) whether it causes substantial injury to consumers (or competitors or other businessmen).<sup>169</sup>

Since the FTC is the administrative agency most familiar with the problems in franchising and has already displayed keen interest in eliminating all fraud and nondisclosure, as well as in the fostering of fair play, with this square affirmation of the breadth of its powers it should now go further to confirm the vested interest of the franchisee in his business and the mutual obligations of good faith.

Possibly the simplest and most effective concept would be to confirm the mutually fiduciary nature of the relationship from its very inception<sup>170</sup> and to acknowledge that while the arrangement commences by contract, a fiduciary status thereafter exists.<sup>171</sup> Such proposals are pending in Massachusetts,<sup>172</sup> Texas,<sup>173</sup> and elsewhere,<sup>174</sup> and have been adopted in Washington.<sup>175</sup> In the field of fraud, the obvious advantages of such generic standards are the imposition of an affirmative duty of disclosure, the impact both at the inception and during the life of the relationship, the unlimited scope of the matters to which they apply, and the established power of equity to fashion appropriate relief through a wide variety of decrees including not only damages, but also mandatory and injunctive orders, rescission,<sup>176</sup> and reformation, all on both temporary and permanent bases.

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<sup>169</sup> *Id.*, from Statement of Basis and Purpose of Trade Regulation Rule 408 (Unfair or Deceptive Advertising and Labelling of Cigarettes in Relation to the Health Hazards of Smoking), 29 Fed. Reg. 8355 (1964).

<sup>170</sup> See note 150 *supra*.

<sup>171</sup> See note 55 *supra*.

<sup>172</sup> Recently submitted as S.252 for consideration by the 1972 Massachusetts legislature, also including registration proposals.

<sup>173</sup> See proposed Franchise Association Act and Franchise Investment and Association Act, each of which proposes to acknowledge the mutual fiduciary obligations of the parties, with the latter proposal also including the regulatory and registration provisions found in the California Franchise Investment Law.

<sup>174</sup> See Comment, *Franchise Regulation: An Appraisal of Recent State Legislation*, 13 B.C. IND. & COM. L. REV. 529 (1972); see also G. A. Pellitier and R. Strauser, *Franchise Handbook* 205 (P.L.I. No. 58, 1971).

<sup>175</sup> See Franchise Investment Protection Act, WASH. REV. CODE ANN. 18.252x § 18 (Supp. 1971) (as amended 1972, effective May 1, 1972) wherein § 18(1) specifies that "the parties shall deal with each other in good faith," restrictions on termination are covered by § 18(2)(j), and failure to renew the franchise is covered by § 18(2)(i). While granting some exemptions comparable to the California Franchise Investment Law, including an almost exact copy of the filing and disclosure requirements for prospective franchisees, the Washington statute also establishes numerous fair dealing requirements, especially a prohibition of the imposition "of any standard of conduct unless the person so doing can sustain the burden of proving such to be reasonable and necessary," in § 18(2)(h). Other provisions include the imposition of up to treble damages, within the court's discretion, in § 19(3) and a limitation of a defense to fraud to only those situations in which the franchisee "knew" the true facts, in § 19(2).

<sup>176</sup> In rescission, restoration of the parties to their prior status should include an allowance

The second effort to secure generic relief has been through attempted application of the broad anti-fraud standards of SEC Rule 10b-5,<sup>177</sup> prohibiting anyone to use a "device, scheme, or artifice to defraud," to "make an untrue statement of a material fact" or to omit a statement necessary to avoid any misleading in a statement made, or to "engage in any act, practice, or course of business" that would operate as a fraud<sup>178</sup> "in connection with"<sup>179</sup> the purchase or sale of a security. Such standards would not only recognize an affirmative duty of full disclosure, but even more cogently, they would encompass statements of opinion, predictions, and even promissory representations, most especially including forecasts of profitability either in descriptive words or in pro forma profit and loss statements, as well as unfounded offers of the franchisor's promised guidance and assistance in all business matters. They would also require a fair explanation of the significance of numerous complex business matters to the unsophisticated and inexperienced franchisee who may be risking his entire life's savings on the intricate business venture being offered by the knowledgeable franchisor. Legally, the investor would be protected not only against intentional misrepresentations, but also against any reckless or culpably negligent<sup>180</sup> failure to verify the facts.

As to whether a franchise is an investment contract of the character covered by federal and state securities acts, much of the confusion arises from a lack of judicial understanding of what is involved in franchising. As distinguished from the simple sale of real estate or even of an independent business, the grant of a franchise involves an investment of capital or time and effort in an on-going business relationship in which there is a community of interest, with the franchisor not only retaining the quality control needed under the Lanham Act, but also a whole array of contractual and other power bases such as the unilateral right to prescribe the franchisee's business methods and practices, the prices to the franchisee, the advertising, the quotas, the manual of operations, all structural and maintenance matters, capitalization, transferability, and renewals. As for the products manufactured by the franchisor and sold to the franchisee, such as in the case of automobiles, gasoline, beer, or hundreds of other items, the franchisor retains absolutely total power over its design, engineering, manufacture, and provision of repair parts. Al-

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to the franchisor for the use of the property, but also compensation for the franchisee during the period of operation. See *Runyan v. Pacific Air Ind., Inc.*, 2 Cal. 3d 304, 466 P.2d 682, 85 Cal. Rptr. 138 (1970).

<sup>177</sup> 17 C.F.R. § 240.10b-5 (1971), adopted pursuant to Securities and Exchange Act of 1934, 15 U.S.C. § 78j (1970).

<sup>178</sup> For the extreme breadth of such prohibitions, see A. BROMBERG, *SECURITIES LAW: FRAUD: SEC RULE 10B-5* (1st ed. 1968); L. LOSS, *SECURITIES REGULATION* (2d ed. 1961 and 1969 Supp.).

<sup>179</sup> See *Superintendent of Ins. of New York v. Bankers Life and Casualty Co.*, 404 U.S. 6 (1971).

<sup>180</sup> See note 143 *supra*.

though franchisee suggestions may be received, because of the disciplinary prerogatives reserved and exercised by the franchisor, the views of franchisees are most often treated with disdain. The franchisor not only retains power to disenfranchise the dealer by denying him a sufficient supply of inventory<sup>181</sup> and parts, but the franchisee may be unable to continue in business with the products available to him only from other sources,<sup>182</sup> a debility of particular severity where the franchisor has directly restricted the franchisee's handling of other such products or has indirectly accomplished the same result by requiring him to devote his entire business activity to the operation of the franchise.

Because of the general lack of familiarity with the facts as well as the law in such a dynamically developing business relationship, until recently, the few district courts which have faced this issue have sustained motions to dismiss<sup>183</sup> based on a sterile application of the early Supreme Court dictum prescribing that:

an investment contract for the purposes of the Securities Acts means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits *solely from the efforts of the promoter* or a third party.<sup>184</sup>

That very definition has been attacked on a number of grounds, most recently on the basis that its underpinnings were unsound,<sup>185</sup> aside from the obvious fact that it was simply dictum and in spite of the court's express imprecation that the investment contract concept

embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.<sup>186</sup>

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<sup>181</sup> See *Junikki Imports, Inc. v. Toyota Motor Co.*, 5 TRADE REG. REP. ¶ 73,911 (N.D. Ill. 1972) (interpreting the good faith requirement of the Auto Dealers Day in Court Act to prohibit a distributor from under supplying its dealer with vehicles as a means of disenfranchising the dealer).

<sup>182</sup> See *Industrial Bldg. Materials, Inc. v. Interchemical Corp.*, 437 F.2d 1336 (9th Cir. 1971) (after termination of dealership for line of industrial chemicals, dealer unable to survive financially with remaining lines).

<sup>183</sup> *Mr. Steak, Inc. v. River City Steak, Inc.*, 324 F. Supp. 640 (D. Colo. 1970) *aff'd and modified* 460 F.2d 666 (10th Cir. 1972); *Abercrombie v. Lum's, Inc.*, C.A. No. 295-70-A, order of April 12, 1971 (E.D. Va. 1971); *McCoy v. Convenient Food Mart, Inc.*, 5 TRADE REG. REP. ¶ 73,873 (D. Neb. 1972); *G & K Foods, Inc. v. Kentucky Fried Chicken*, No. 71-5 Civ. Ft. M. (M.D. Fla. 1972); *Cobb v. Network Cinema Corp.*, 5 TRADE REG. REP. ¶ 74,011 (N.D. Ga. 1972) (strict reliance on *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946)).

<sup>184</sup> *SEC v. W. J. Howey Co.*, 328 U.S. 293, 298-99 (1946). In the absence of the franchisee's active business participation, a franchise has been held to be an investment security. *Lennerth v. Mendenhall*, 234 F. Supp. 59 (N.D. Ohio 1964).

<sup>185</sup> See the scholarly analysis of the *Howey* antecedents in Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135 (1971).

<sup>186</sup> *SEC v. W. J. Howey Co.*, 328 U.S. 293, 299 (1946); see forceful comment to like effect by Mr. Chief Justice Warren in *Tcherepnin v. Knight*, 389 U.S. 332 (1967), quoting *SEC v. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943):

Novel, uncommon, or irregular devices, whatever they appear to be, are also reached

In that very decision, the Supreme Court concluded with the clear warning that "The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic or irrelevant formulae."<sup>187</sup> Relying on such standards, as well as the frequently repeated warning against the allowance of a motion to dismiss, particularly in complex matters, unless it would be impossible to sustain a claim, at least one district court has therefore refused to dismiss such a complaint, without a full factual examination.<sup>188</sup> Reviewers have been less reticent, very creditable arguments having been made that the ministerial scope of discretion consigned to the franchisee as against the grossly disparate authority retained by the franchisor, satisfies the test of "profits solely from the efforts" of others.<sup>189</sup> After meticulous examination of the judicial history and an appraisal of the economic realities, other scholars have evolved new definitions that would include the franchise as an investment contract while excluding the straight business transaction.<sup>190</sup>

Perhaps one of the more authoritative assaults on the "profits solely" test has developed from the so-called "risk capital" test in which there has been a partially appropriate result, though the theory is based on a confusion of proof with a question of principle. Originally adopted by the California Attorney General and then accepted by others,<sup>191</sup> the conclu-

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if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as "investment contracts" or as "any interest or instrument commonly known as a 'security.'"

*Id.* at 351.

<sup>187</sup> 328 U.S. at 301.

<sup>188</sup> *Beefy Trail Inc. v. Beefy King International, Inc.*, C.A. No. 70-246-ORL-CIV (M.D. Fla. April 23, 1971). See also *Phillips v. Magnetico International, Inc.*, No. 72-77-ORL-CIV, Order of July 3, 1972 (M.D. Fla. 1972) (citing his identical conclusion in *Beefy Trail*, Judge Young postponed any definitive ruling as to whether an exclusive territorial distributorship for the sale of computerized beer controls was an "investment contract" under the state and federal securities acts, until further development of the facts).

<sup>189</sup> See Goodwin, *Franchising in the Economy: The Franchise Agreement as a Security Under Securities Acts, Including 10b-5 Considerations*, 24 BUS. LAW. 1311 (1969); accord *Commissioner of Sec. v. Hawaii Mkt. Center, Inc.*, 485 P.2d 105 (Haw. 1971); Augustine & Hrusoff, *Franchise Regulation*, 21 HAST. L.J. 1347 (1970); Coleman, *A Franchise Agreement: Not a Security Under the Securities Act of 1933*, 22 BUS. LAW. 493 (1967); Green, *The Regulation of Franchising Under the Securities Laws*, 6 GA. S. B.J. 357 (1970); Note, *Securities—Founder Purchase Contracts—"Contract" Defined*, 21 MERCER L. REV. 715 (1970).

<sup>190</sup> See J. C. Long's superb work, *supra* note 185, at 174, concluding with:

A security is the investment of money or money's worth in the risk capital of a venture with the expectation of some benefit to the investor where the investor has no direct control over the investment or policy decisions of the venture.

See comparable definitions in Coffey, *The Economic Realities of a 'Security': Is There a More Meaningful Formula?*, 18 WEST. RES. L. REV. 367 (1967); Note, *Franchising as a Security*, 33 OHIO ST. L.J. 718 (1972).

<sup>191</sup> 49 OP. ATT'Y GEN. (Cal.) 124, 3 BLUE SKY L. REP. ¶ 70,747 (1967); OP. ATT'Y GEN. (Ga.) No. 69-471, 3 BLUE SKY L. REP. ¶ 70,850 (Nov. 14, 1969); and OP. ATT'Y GEN. (Utah), 3 BLUE SKY L. REP. ¶ 70,893 (Jan. 7, 1971). The California opinion relied heavily on the case of *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961), involving the purchase of memberships in an incipient country club de-

sion is based on the fact that when an entity is grossly undercapitalized and then obtains its capital funds from others, including a direct or indirect payment by a franchisee beyond the direct value of acquired tangibles, then it follows that an investment must have been involved. Such reasoning is reminiscent of the asset test in taxation matters, its application in that arena being that if the taxpayer has extensive capital assets without reasonable proof that they could have been acquired in his reported income or from other explainable sources, then it must be assumed that there was additional income which had not been reported. Although the "risk capital" test is correct where applied, its rationale actually confirms the fundamental principle that all franchisors obtain capital from their franchisees, whether that capital is the source of the original equity in the franchisor or whether it is an accretion to existing capital.

It is submitted that the real difficulty arises from the failure of the courts to have grasped the true nature of the franchising relationship and even more so, the incredible extent of the fraud and opportunity for fraud inherent in franchise practices, particularly in the original grant of the franchise. The proof of this speculation lies in the curious development under which "pyramid sale" schemes have more rapidly come under judicial and legislative control even though the same legal and factual arguments are even more applicable in franchising.<sup>192</sup>

Pressed by the mathematical conclusion that "pyramid" investors are practically doomed to fail,<sup>193</sup> the severity of the fraud has finally induced some courts to adopt a further alternative, referred to as the "economic realities" test.<sup>194</sup> Under that test, the court held that an investment contract exists where:

- (1) An offeree furnishes initial value to an offeror, and
- (2) a portion of this initial value is subjected to the risks of the enterprise, and
- (3) the furnishing of the initial value is induced by the offeror's prom-

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velopment which had no original capital, and in which the benefit to the putative investor was not directly a matter of profit.

<sup>192</sup> Iowa was the tenth state to bar pyramid sale schemes by statute. *National Observer*, Dec. 4, 1971, p. 9, col. 1. See also Note, *Dare to be Great, Inc.: A Case Study of Regulation of Pyramid Sales Plans*, 33 OHIO ST. L.J. 676 (1972). In *Oregon v. Consumer Business System, Inc.*, 482 P.2d 549 (Ore. Ct. App. 1971) the court utilized the "risk capital" as an alternate to the "profits solely" standard.

<sup>193</sup> While the last cited case involved a so-called "founder-membership" contract in which the putative investor sold discount membership cards, then received his income from a commission on all purchases made by the member from the parent company, it does not materially differ from the "pyramid sale" scheme nor even from the "area franchise" arrangement. In each instance, the implicit fraud arises from the fact that since the number of prospects is limited, a reasonable opportunity for the investor to succeed would be mathematically impossible. It is usually conceded that a few of the original investors may do well until the market inexorably evaporates.

<sup>194</sup> *Commissioner of Sec. v. Hawaii Mkt. Center, Inc.*, 52 Ha. 642, 646, 485 P.2d 105, 109 (1971); *Florida Discount Centers, Inc. v. Antinori*, 232 So. 2d 17 (Fla. 1971); *contra*, *Koscot Interplanetary, Inc. v. King*, 452 S.W.2d 531 (Tex. Civ. App. 1970).

ises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and

- (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.

Shortly thereafter, the Chairman of the SEC formally announced that henceforward the Commission would not only apply the same "economic realities" test and thus include "pyramid schemes" within the definition of a security, but that thereafter a formal registration statement would be required.<sup>195</sup>

While it is perfectly obvious that the franchise format fully satisfies these newly devised standards, in his formal release, the SEC Chairman still hearkened to the "profits solely" test by stating that in the Commission's opinion, there is an offer of a security where "prospective participants are led to believe that they may profit from participation in these distribution programs without actually assuming the significant functional responsibilities that normally attend the operation of a franchise." His seeming exclusion of franchising by that qualifying phrase runs contrary to both fact and law.

In the very same formal release, the SEC Chairman directly quoted the Hawaii decision's warning that

courts (might) become entrapped in polemics over the meaning of the word 'solely' and fail to consider the more fundamental question whether the statutory policy of affording broad protection to investors *should be applied even to those situations where an investor is not inactive, but participates to a limited degree in the operation of the business.*<sup>196</sup>

And in announcing that radical departure from the strictures of the *Howey* case, the court went further to cite with approval a leading article devoted to the thesis that both by contract and in practice, the franchisee's scope of authority is so limited as to be essentially ministerial, sufficient to bring it within the severe test of the *Howey* case.<sup>197</sup>

Rejecting the exclusive application of the *Howey* case, after a full trial, a Colorado federal district court has held that an exclusive territorial franchise for the sale of correspondence courses is an "investment contract" within the definition of a security in the Colorado Licensing and Practice Act. On the matter of control, the court ruled:

Plaintiffs had no actual control over the business that was being franchised. Defendant could have refused to furnish course material to per-

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<sup>195</sup> See Securities Act of 1933, Release No. 5211, and Securities Exchange Act of 1934, Release No. 9387, both released as a single document on November 30, 1971.

<sup>196</sup> 52 Ha. at 646, 485 P.2d at 108 (emphasis supplied).

<sup>197</sup> Goodwin, note 189 *supra*.

sons to whom plaintiffs had made sales; defendant could have changed the material sent to the students; and defendants could have, without plaintiffs' approval or knowledge, gone out of business leaving plaintiffs without a product to sell.<sup>198</sup>

Obviously, almost every franchisor retains such controls as a bare minimum, with far more pervasive power in most cases. As for the fraud involved, the court found misrepresentations as to the length of time the franchisor had been in business (three years instead of twelve years), the record of performance (only eight franchises had been sold and none had done the reported sales), the licensing of the educational courses (Colorado had not granted a license), the calibre and experience of the franchisor (not a "team of experienced personnel who had been successful businessmen," but rather a one-man operation), and the franchisor's initial support efforts (no intention to personally secure the first twenty enrollments).

Noting that "a definite judicial trend is discernible which redefines 'investment contracts' in realistic economic terms rather than the narrow interpretation indicated by the *Howey* case," the court noted with approval the principle enunciated by the Hawaii supreme court,

emphasiz[ing] the remedial purposes of that state's securities act, and [holding] that participation on the part of an investor in a way which is not controlling or decisive in the profit-making aspects of the business would not deprive the investor of his relief.<sup>199</sup>

Applying such principles, the Colorado court held that the "initial value" was furnished by the franchisee and "subjected to the risk of the enterprise," and on the alternatively crucial issue of control, that "the franchisee did not have any supervision or control over the managerial decisions of the business enterprise."<sup>200</sup> Since that case is the first in the nation to consider the basic issues after a plenary exposition of all the facts in an actual trial, as compared with the sterile process in a motion to dismiss, such a considered judgment should carry much weight elsewhere.

The extent of the franchisor's pervasive control has been both judicially and administratively acknowledged. In an FTC proceeding against

<sup>198</sup> *Venture Investment Co., Inc. v. Shaefer*, C.A. No. C-2732—Order of June 15, 1972, (D. Colo. 1972), applying the Colorado Licensing and Practice Act, COLO. REV. STAT. ANN. §§ 125-1-12, 125-1-21 (1963).

<sup>199</sup> See note 196 *supra*.

<sup>200</sup> In a June 2, 1972, decision, the chief judge of an Oklahoma state court held that the sale of "dealer and key dealer contracts" were sales of securities under the State statute (OKLA. STAT. ANN. tit. 71, § 2(1) (1965)), relying upon the fact that "the dealers have no part in management. . . . The dealers had no voice in the policies of the corporations," noting "it would make a mockery . . . to den[y] investors the very protection they need when confronted with a sophisticated and plausible scheme which promises profits in the future, but with no assurance that there will ever be any sound economic basis for the generation of profits or that the corporation will last long enough for the investor to even recover his original investment, let alone any profit." *State v. World Mkt. Centers of Okla., Inc.* No. CJ-72-1575 (Okla. County D. Ct. 1972).

a major oil company charging that it received rebates from the suppliers of tires, batteries, and accessories, with whom the gasoline station dealers were induced to do business, there was admittedly no evidence of overt compulsion by the franchisor.<sup>201</sup> The United States Supreme Court nonetheless found that control existed in view of the franchisor's power, hinged on the short term subleases, coupled with the fact that the franchisees were well aware of what was expected of them. In even more direct language, the FTC held an automatic transmission franchisor liable for the false and deceptive advertising by its franchisees, based on the fact that the advertising was designed by the franchisor and the franchisees knew they could be terminated if they failed to obey the instructions of the franchisor.<sup>202</sup>

There is thus created the anomalous situation in which a regulatory agency with no particular expertise in franchising has enunciated new standards which could clearly encompass franchising, together with a wholly unfounded factual intimation that franchising may be beyond the standards. The unexpressed reason for this patent abdication of the rule of law lies in the administrative desire of the SEC not to be burdened with the regulation of franchising, leaving that field to the Federal Trade Commission. In addition to the work-load factor, the SEC has acknowledged the expertise of the FTC in competitive regulatory matters. That very position was publicly announced in the 1970 Congressional testimony of Philip Loomis, then General Counsel, now a Commissioner, of the SEC.<sup>203</sup>

It is, of course, erroneous to hold that the severity of the fraud or the likelihood of the investor's failure should be the sole determinant of whether there is an investment contract, though if such were the test, then it can easily be demonstrated that many franchises are either designed to fail or so recklessly conceived that the same result ensues. Similarly, the "risk capital" test is merely a way to prove that venture capital was involved. Indeed, in one of the more recent assaults on the "pyramid scheme," it has been held that the "risk capital" test should not be limited to "initial capital," but "should also apply to schemes to raise capital for existing but unproven business as well as schemes to raise initial capital."<sup>204</sup> Quite appropriately, the court so concluded, after it stated:

<sup>201</sup> *FTC v. Texaco, Inc.*, 393 U.S. 223 (1968).

<sup>202</sup> *AMCO Automatic Transmissions Inc.*, 3 TRADE REG. REP. ¶ 19,283 (F.T.C. 1970) and *FADE REG. REP. ¶ 19,425* (F.T.C. 1970). See *The Southland Corporation*, 3 TRADE REG. REP. ¶ 20,015 (F.T.C. 1972) (Proposed complaint against giant convenient food market franchisor alleging its use of the purchasing power of the franchisees and the "stores" division as a lever to procure reciprocal purchases from its "industrial chemicals" division).

<sup>203</sup> See *Mr. Steak, Inc. v. River City Steak, Inc.*, 324 F. Supp. 640 (D. Colo. 1970) *aff'd* and *modified* 460 F.2d 666 (10th Cir. 1972) (holding that a franchise is not a security, relying strongly on Mr. Loomis' quoted testimony. See 1970 *Hearings*, note 5 *supra*).

<sup>204</sup> *Idaho Com. of Fin. v. Glenn Turner Enterprises, Inc.*, Civ. No. 47773 (Idaho, Mar. 29, 1972).



The unwary and gullible investor can be fleeced much more readily by the older, more affluent company which has long been in business. A money-short, small operation which is just attempting to get started, probably would have more difficulty in extracting money from the naive.<sup>205</sup>

Properly viewed, while it is clear that the franchisee invests either cash or his time and effort in the business enterprise, it is equally evident that the entire business remains under the essential control of the franchisor both in law and in fact.<sup>206</sup> Further, instead of there being merely the sale of an income producing property or a business to the franchisee, there is a continuity of income to the franchisor either through a royalty on gross sales, rentals, or the sale of products or services. This community of interest in the on-going business enterprise, subject to the franchisor's control, provides the essential key to the relationship. Stated otherwise, the franchisee is induced to place his faith and confidence in the business skills and expertise of the franchisor in a complex undertaking of long duration, where the franchisee is expressly lacking in experience. In substance, the very standards which would appear to create a fiduciary relationship would be of comparable significance in establishing the transaction as a security. Of equal interest, many of the same consequences would flow from both concepts, principally in the area of a duty of full disclosure and explanation, as well as an absence of clandestine self-preference. In simplest terms, the investment contract involves the franchisee's acquisition of a share of the goodwill previously developed by the franchisor and the other franchisees in the servicemark and logo, to which he will thereafter contribute his pro rata share subject, however, to its total control by the franchisor.<sup>207</sup>

Perhaps by way of anticlimax, it is quite probable that almost all

<sup>205</sup> *Id.*; see also *Milsen v. Southland Corporation*, 5 TRADE REG. REP. ¶ 73,774 (7th Cir. 1971) (recognizing "the vested interest a franchisee builds in his business through years of effort and expenditures").

<sup>206</sup> In income tax litigation, it has consistently been held that the grant of a franchise is not a "sale" because the franchisor retains a substantial degree of control. *Dairy Queen of Oklahoma v. Commissioner*, 250 F.2d 503, (10th Cir. 1957); *Moberg v. Commissioner*, 310 F.2d 782 (9th Cir. 1962); *United States v. Werentin*, 354 F.2d 757, 763 (8th Cir. 1965).

<sup>207</sup> See *Kugler v. Aamco Automatic Transmissions, Inc.*, 5 TRADE REG. REP. ¶ 73,986 (D. Minn. 1971); *aff'd* 5 TRADE REG. REP. ¶ 73,978 (8th Cir. 1972). While holding that the grant of a franchise and the franchisee's compulsory contribution to national advertising conducted were a single product, thus precluding an antitrust "tying" violation, the district court stated:

What the franchisee expects to purchase is the right to use the trademark with all the continuing goodwill and consumer recognition that goes with it. . . . What [the franchisee] gains by becoming associated with the franchisor is the national goodwill created by national advertising. If there were no national image there would be little value to ownership of a franchise.

*Id.* at ¶ 73,186. Equally clear, the franchisor's complete control of such national advertising as the very "essence of the license" establishes the economic reality of the franchisee's acquisition of a standard "investment contract" fully controlled by the franchisor. See *McCarthy, Trademark Franchising and Anti-Trust: The Trouble with Tie-ins*, 58 CAL. L. REV. 1085, 1089 (1970).

franchisees can obtain this very protection without a finding that the franchise itself is a security. This arises from the statutory definition which expressly includes a promissory note as a security,<sup>208</sup> combined with the fact that there is almost always a promissory note or other promise to pay money issued by the franchisee in connection with the grant of the franchise. Since there is no requirement that such a note be negotiable, any promise to pay money will satisfy the standard even if there be other specified conditions or executory promises of the parties. Just as clearly, the protection of SEC Rule 10b-5 is available wherever there is the purchase or sale of stock in the franchise corporation itself, be it but a single share of stock in a one-man corporation.<sup>209</sup> Of equally broad consequence is the recent confirmation by the U.S. Supreme Court that the protection of SEC Rule 10b-5 is available wherever there is such fraud "in connection with" the purchase or sale of a security, without any necessity of showing that the fraud was perpetrated in such a transaction, that there was privity, or that the damages flowed from it, the statutory phrase "in connection with" being jurisdictional in nature, rather than the governor of the fraud transaction.<sup>210</sup>

The third statutory approach has been special regulation requiring the public filing of a whole array of specific data regarding almost every important aspect of the franchise, together with a requirement of presentation to a prospective franchisee and even a cooling-off period. The first such statute became effective in California on January 1, 1971, specifically requiring pertinent data as to financial, control, supply, and identification information, as well as the public filing of a prospectus and the licensing of franchise salesmen.<sup>211</sup> As compared with other proposals, the California statute is considerably weakened by several provisions, starting with coverage only where a capital fee is charged for the franchise. Adopted as a device to alleviate the administrative burden, the definition is wholly unrealistic and merely facilitates evasion.

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<sup>208</sup> See 15 U.S.C. § 78c(a)(10) (1970), expressly defining such a promissory note as a "security." While such a note is exempt from registration requirements if its due date is less than nine months, the anti-fraud provisions of SEC Rule 10b-5 are in no way dependent upon the necessity for registration.

<sup>209</sup> As provided in SEC Rule 10b-5, it is unlawful "for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange" to employ manipulative or deceptive devices, such extensive jurisdiction arising not only wherever the mails are used, but also from the use of the telephone, even an intrastate message being regarded as part of the interstate system. See *Lennarth v. Mendenhall*, 234 F. Supp. 59 (N.D. Ohio 1964).

<sup>210</sup> See *Superintendent of Ins. of New York v. Bankers Life and Casualty Co.*, 404 U.S. 6 (1971) allowing direct recovery by a creditor or a defrauded bank, thus stressing that "in connection with" does not require privity, causation, or damages to flow directly from the transaction, and citing with approval Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968) suggesting precisely that broad scope of its applicability.

<sup>211</sup> CAL. CORP. CODE §§ 31111, 31124 (West Supp. 1971).

While large companies must give comparable information to prospective franchisees, they are exempt from a public filing, perhaps the first time in regulatory history that "bigness" has been equated with "honesty." Further, a fraud claim can be defeated if the prospective franchisee knew or should have known the truth, the first time that contributory negligence has been made a defense to fraud.<sup>212</sup> And, finally, recovery is limited to the actual damages rather than providing for exemplary, double, or treble damages, thus providing the weakest kind of deterrent since, at worst, fraudulent franchisors need only fear the loss of a portion of their booty. In sharp contrast, the recently enacted Washington statute has eliminated all of these shortcomings and, in an admirable desire to achieve as much uniformity as possible, the disclosure requirements are verbatim with the California statute.<sup>213</sup> In pending proposals, other states and even the Province of Ontario have tried to adhere to the same principle of uniformity.

For example, Wisconsin has recently enacted a "disclosure" type statute<sup>214</sup> that is quite similar to the disclosure provisions of the Washington statute. While it lacks the deterrent of discretionary treble damages, in addition to simple damages,<sup>215</sup> it provides for enforcement by the Commissioner of Securities,<sup>216</sup> injunctions,<sup>217</sup> and even criminal sanctions.<sup>218</sup> Either as a matter of legislative necessity or because of effective franchisor lobbying, there are exemptions from public filing for large companies,<sup>219</sup> as in the California and Washington statutes, though similar information must nevertheless be given to the prospective franchisee at least 48 hours before the signing of the franchise agreement.<sup>220</sup>

Under the administrative rules for the Wisconsin statute, an attempt has been made to specify the many areas in which affirmative disclosure is acutely necessary, such as on matters involving profitability, the experience and financial strength of the franchisor, and the actual record of

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<sup>212</sup> See *Yorke v. Taylor*, 332 Mass. 368, 124 N.E.2d 912 (1955) (seller's innocent misrepresentation of assessed valuation of real estate is actionable and it is no defense that the buyer could easily have verified the correct valuation at the Town Assessor's Office); *Sandler v. Elliott*, 335 Mass. 576, 141 N.E.2d 367 (1957) (plaintiff's lack of diligence nor a defense to fraud in the sale of a franchise).

<sup>213</sup> WASH. REV. CODE ANN. § 19.100.010 (1972) (Washington Legislative Service, 1972, ch. 116); see also note 175 *supra*.

<sup>214</sup> WIS. STAT. ANN. §§ 553.01-.78 (1972). (West's Wisconsin Legislative Service, 1972).

<sup>215</sup> *Id.* § 553.51.

<sup>216</sup> *Id.* § 553.71.

<sup>217</sup> *Id.* § 553.54.

<sup>218</sup> *Id.* § 553.52.

<sup>219</sup> *Id.* § 553.22.

<sup>220</sup> *Id.* § 553.22(3)(a)-(n). Reflecting the view that disclosure at that time is too late, the proposed FTC regulation would require presentation "at the time when contact is first established." F.T.C. Proposed Rule, 4 TRADE REG. REP. ¶ 38,029, § 436.1(a) (F.T.C. 1972).

other franchisees.<sup>221</sup> In the first subsection, the rules establish a presumption of "false, fraudulent, or deceptive practice" in eighteen categories of information if the franchisor fails to supply essential corroboration.<sup>222</sup> For example, on the extremely sensitive issue of compulsory purchases from designated vendors, there is a presumption of fraud if a representation is made regarding required purchases from specific sources "without disclosure of the affiliation . . . between such sources and the franchisor and the relationship of the prices . . . to the prevailing prices."<sup>223</sup> As to such crucial factors as the franchisor's role in training, site location, and marketing, any representation is presumed to be fraudulent if it fails to cite the contractual provisions, if any, which obligate the franchisor to accomplish the same.<sup>224</sup> Through such amplification of the statutory proscription of fraud, the rules particularize the kind of information needed for an intelligent decision. At the same time, they would compel disclosure of illegal or reprehensible practices. It may not be improper to presume that prospective franchisees elsewhere should attempt to obtain the same information that is required to be given in states which have enacted disclosure statutes. The same information could be of importance in pending litigation. Finally, although such statutes forego direct relief to franchisees for fraudulent or anticompetitive practices after the grant of a franchise, the Wisconsin rules assign a powerful administrative sanction to the Commissioner by enabling him to issue a stop order or to revoke any registration where he finds that the sale of a franchise "is or would be in violation" of the antitrust laws or the Federal Trade Commission Act.<sup>225</sup> As for the materials which must be disclosed, substantial uniformity is thus being achieved by many States, simply as a matter of comity.

With that very standard in mind, recently filed bills<sup>226</sup> would expressly grant to the FTC power to prescribe by regulation certain categories of information which franchisors must publicly file and present to prospective franchisees, making failure a violation of § 5 of the FTC Act, but also providing for the first time for private enforcement through an action for violation of the deceptive practices prohibition, with treble damages and counsel fees. Because of the intense apprehension of franchisors that many states will enact differing versions of disclosure regulations, such proposals have been given excellent chance of enactment.

It is, nevertheless, fair to point out that the disclosure provisions

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<sup>221</sup> WIS. STAT. ANN. § 34.01 *et seq.* (effective July 1, 1972).

<sup>222</sup> *Id.* § 34.02(1).

<sup>223</sup> *Id.* § 34.02(1)(b).

<sup>224</sup> *Id.* § 34.02(1)(s).

<sup>225</sup> *Id.* § 33.02.

<sup>226</sup> S. 2399, 92d Cong., 1st Sess., introduced August 2, 1971, by Senator Williams, and S. 2870, 92d Cong., 1st Sess., introduced November 17, 1971, by Senator Hartke.

are not identical with those enacted in California and Washington, and that the federal act would be preemptive. By providing for a public filing of the required information with the FTC, the legislation adopts the advice given by the late Mr. Justice Brandeis that "sunlight is indeed the best of disinfectants."<sup>227</sup> While the statute would not expressly require "good faith" and "fair dealing," the regulatory power of the FTC would expressly encompass specific areas such as direct franchisor competition, unfairly induced sale of the franchise, and unprotected termination, cancellation or failure to renew the franchise.

Seeking to justify its focusing on misrepresentation in the sale of franchises, FTC spokesmen have pointed out that in its recently completed study of franchising, eighty percent of the complaints received from franchisees emphasized that they had not been told the full story in advance, that many matters were erroneously described, and that they had no genuine idea of what they were really getting into when they acquired their dealerships.<sup>228</sup> In all probability, the same complaint could be made by almost every franchisee, even those for whom matters worked out well. It is, however, foolhardy to imply that the uninitiated franchisee should be able to articulate the objections to the complex antitrust and unfair competitive practices of which so many franchisors are guilty.<sup>229</sup>

Under its existing statutory authority, the FTC has initiated proceedings for the promulgation of a Trade Regulation Rule concerning franchising.<sup>230</sup> In substance, the proposed regulation would follow the same general outline as the California Investment Law, specifying 27 particular areas of required information to be supplied to prospective franchisees and to the Commission; prescribing the bases for certain financial calculations and substantiation;<sup>231</sup> and calling for various notices, a cooling off period of ten days, express notice precluding negotiation in due course of any promissory note unless free of franchisor involvement, and express saving clauses for anticompetitive regulation under federal or state law.<sup>232</sup>

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<sup>227</sup> L. BRANDEIS, *OTHER PEOPLE'S MONEY, AND HOW THE BANKERS USE IT*, at 92 (1914).

<sup>228</sup> See *THE ECONOMIC EFFECTS OF FRANCHISING*, *supra* note 7, especially ch. 5, "The Operation of Fast Food Franchised Businesses" and ch. 8, "Commentary on Fast Food Franchise Agreements," each of which contains extensive quotations from franchisees' letter complaints.

<sup>229</sup> See *Bogosian v. Gulf Oil Corp.*, 5 TRADE REG. REP. ¶ 73,784 (E.D. Pa. 1971); transfer denied where nationwide conspiracy, *id.* at ¶ 73,796; allowed "nationwide conspiracy" amendment in antitrust complaint in spite of plaintiff's factual ignorance, *id.* at ¶ 73,816.

<sup>230</sup> Such formal notice was issued November 10, 1971, calling for public hearings February 14-16, 1972; see 4 TRADE REG. REP. ¶ 38,029, Proposed Rule Involving Disclosure Requirements and Prohibitions Concerning Franchising.

<sup>231</sup> For general discussion of such FTC power, see Note, "Corrective Advertising" Orders of the Federal Trade Commission, 85 HARV. L. REV. 477 (1971).

<sup>232</sup> See Rosenfield, *A Look at the Proposed FTC Rule of Franchising*, 27 BUS. LAW. 907 (1972).

Although the specified list of information is somewhat different from that prescribed in the California Investment Law, its scope and draftsmanship are superior to that enactment. If promptly adopted, it will fill the void for the well over forty states which have no such protection. At the same time, it may avoid a patch-quilt of inconsistent regulations across the nation that could seriously impede compliance. While violators would be subject to the normal sanctions available under the FTC Act, it is open to serious question whether compliance can be obtained by a simple cease and desist order after lengthy delays occasioned in part by an overburdened staff, such "delay profit" for violators being a generic problem for most FTC orders.<sup>233</sup> The basic shortcomings are the absence of specific statutory authority, preemptive right over conflicting state regulations, power to obtain temporary injunctive relief, and, of greatest consequence, private enforcement with treble damages. Since all of these problems would be solved in pending legislation,<sup>234</sup> perhaps it may be anticipated that Congressional action will follow the FTC proceedings for, without such basic sanctions, it is debatable whether it were better to allow events to take their present course in litigation and a veritable surge of state enactments. In any event, for the time being no further action is anticipated because the power of the FTC to issue any industry-wide regulation has been successfully challenged in a district court;<sup>235</sup> promulgation of a general regulation on disclosure must therefore await appeal<sup>236</sup> or specific legislative sanction.<sup>237</sup>

#### IV. CONCLUSION

For those who may complain that full disclosure would destroy the very concept of franchising, no answer is genuinely required. For those who may declare that the franchisee is seeking a guarantee of success without hard work, this author has tried to formulate what it is fair to expect when a franchise is granted:

Perhaps equity will at long last acknowledge the basic principle that when a franchisor either sells or grants a franchise to which the franchisee devotes his capital and labor, the franchisee is entitled to a reasonable opportunity to succeed. This principle would require that the franchisor perform its function of developing and maintaining a franchise

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<sup>233</sup> See *supra* note 231, at 482-84.

<sup>234</sup> See note 266 *supra*.

<sup>235</sup> *National Petroleum Refiners Ass'n. v. FTC*, 5 TRADE REG. REP. ¶ 73,910 (D.D.C. 1972); FTC notice of appeal posted May 8, 1972, 21 TRADE REG. REP. 12 (1972) (successful challenge to FTC authority to promulgate industry-wide trade regulation on posting of gasoline octane ratings).

<sup>236</sup> *Id.*

<sup>237</sup> On April 19, 1972, at the meeting of the ABA Antitrust Section in Washington, an urgent plea for prompt remedial legislation was made by FTC Chairman Miles Kirkpatrick, 16 TRADE REG. REP. 6 (1972).

system reasonably capable of fulfilling this implicit representation to the prospective franchisee. Within reasonable limits it would impose restraints upon the capital charge for a franchise, the amount of the royalty in the form of a percentage on gross sales, and all other charges, based on the underlying requirement of a sufficient remainder for the franchisee to obtain a fair return for his investment and effort. Although the franchisee should not expect a guaranty of success, the franchisor should be prepared to demonstrate reasonable proof of sound concepts and empirical testing. While the franchisee should then expect to be subject to the normal competition of the marketplace, he should be totally free from both direct and indirect competition emanating from the very franchisor from whom he acquired his business opportunity. Finally, subject to reasonable controls by the franchisor in the operation and disposition of the franchise, it must be recognized that the franchisee is the owner of an independent business, entitled to the full protection of that asset which the law affords to every other businessman.<sup>238</sup>

This long list of factual complaints, as well as an argument for the fullest implementation of both substantive and procedural rules in order to protect franchisees, might be sarcastically criticized as an over-reaction to the abuses which have continued to this date. Yet if franchising is to fulfill its national claim as the last frontier for the small businessman, it certainly cannot establish such a foundation on fraud in any form. Profit must be taken out of all such misrepresentation, regardless of the cost. In fact there is ample proof that a legitimate joint venture can be maintained in franchising without resort to such abusive tactics. Those very assumptions underlie all current legislative efforts.

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<sup>238</sup> See *Fiduciary*, *supra* note 22, at 674-75. Obviously, such protection would include the anticompetitive prohibitions of the antitrust laws. See note 82 *supra*.